

The Australian economy and property markets

Presentation to a lunch for the
Property Council of Australia

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ANZ

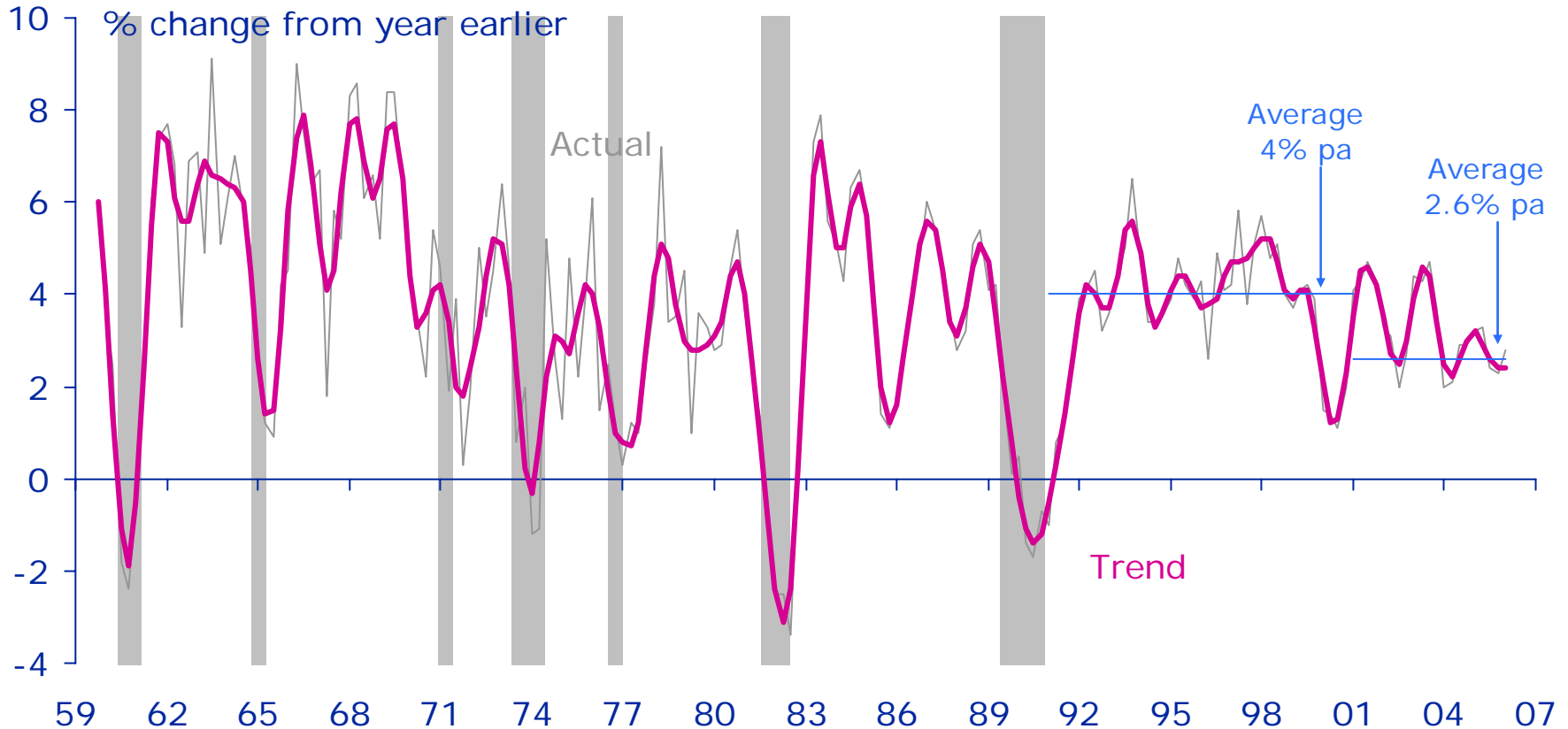
Crown Complex
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1st June 2007

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Australia has now gone more than 15 years without recession, the longest in its history

Real GDP growth



Note: shaded intervals denote periods in which real GDP growth was negative for two or more quarters, or during which real GDP declined from the year-earlier quarter.

Sources: Australian Bureau of Statistics; Economics@ANZ.

Unemployment is at a 30-year low, while a record proportion of the population is employed

Unemployment



Employment-to-population ratio



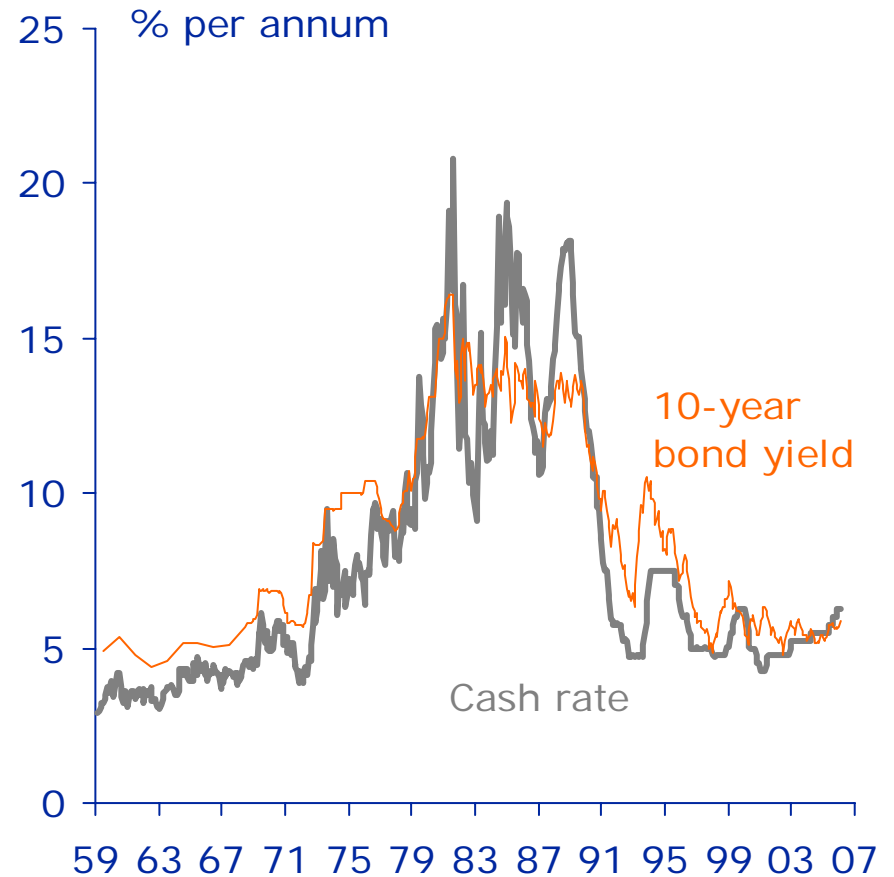
Sources: ABS; Economics@ANZ.

Inflation and interest rates, though rising, are still low by historical standards

Inflation



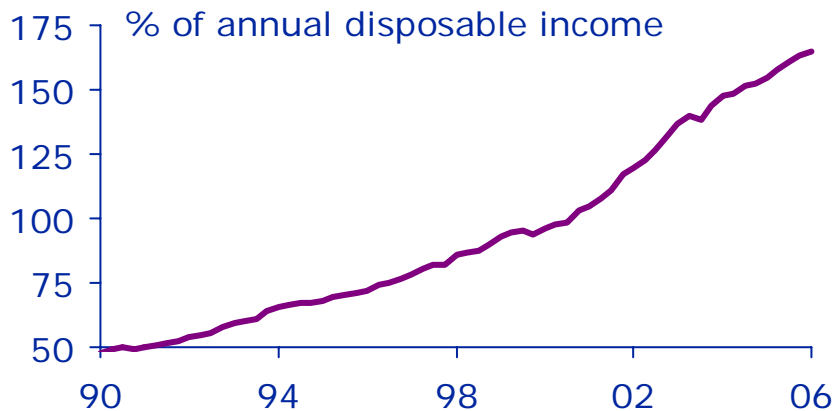
Interest rates



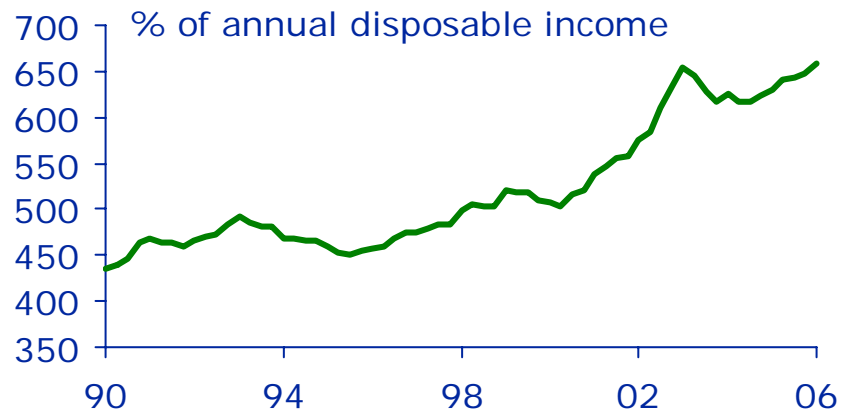
Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

Household indebtedness has risen but household balance sheets are still in excellent shape

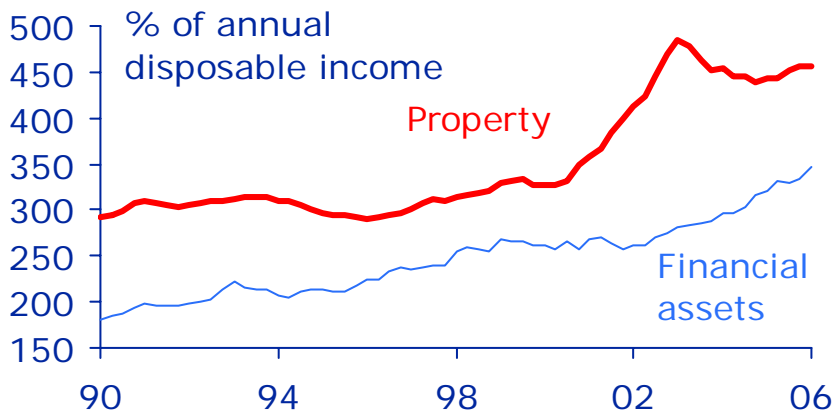
Household debt to income



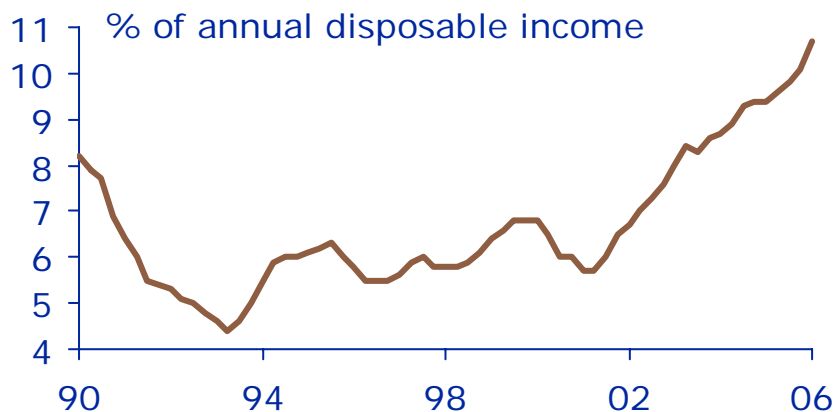
Household net worth to income



Household assets to income



Interest payments to income



Sources: Australian Bureau of Statistics; Reserve Bank of Australia; Economics@ANZ.

And the corporate sector is in substantially better financial shape than 15 years ago

Non-financial corporate sector debt-equity ratio



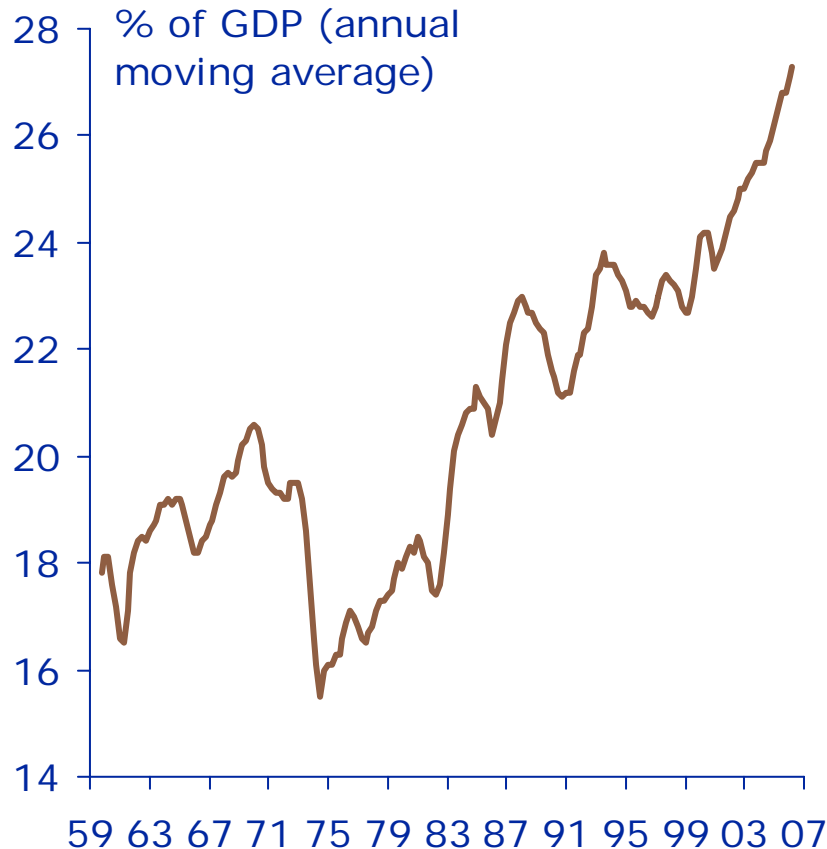
Non-financial corporate sector interest cover



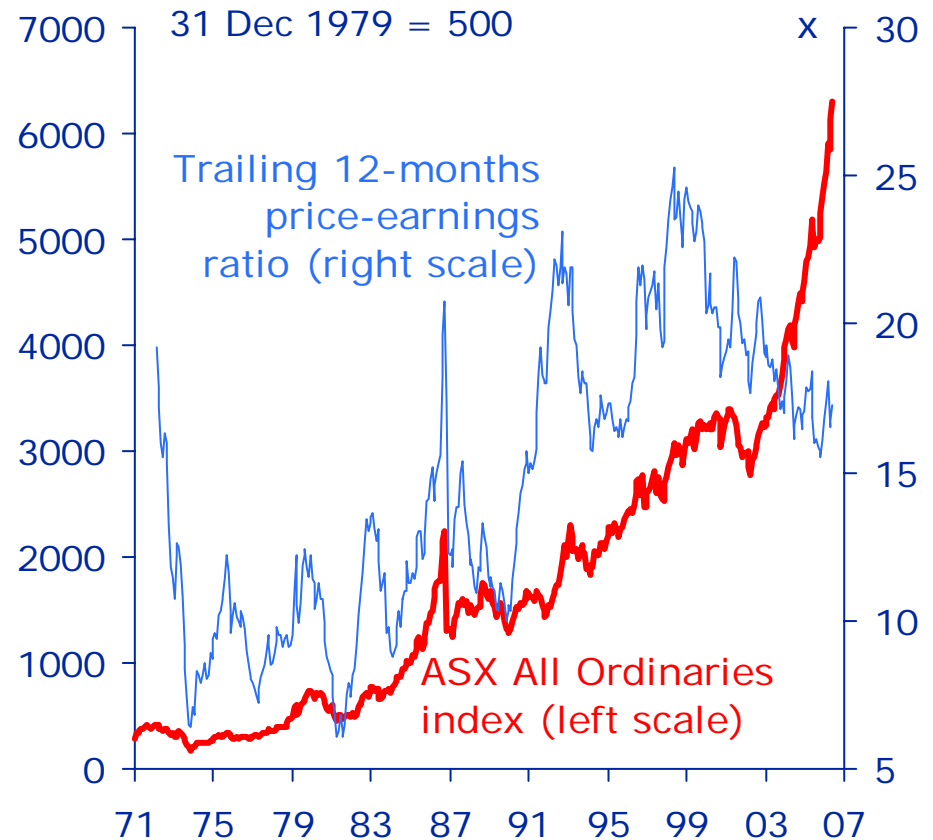
Note: 'interest cover' is the ratio of gross operating surplus (roughly equivalent to EBITDA) to net interest paid. Sources: ABS; Economics@ANZ.

Corporate profits and the share market are at record highs – but the market isn't 'over-valued'

Non-financial corporate gross operating surplus



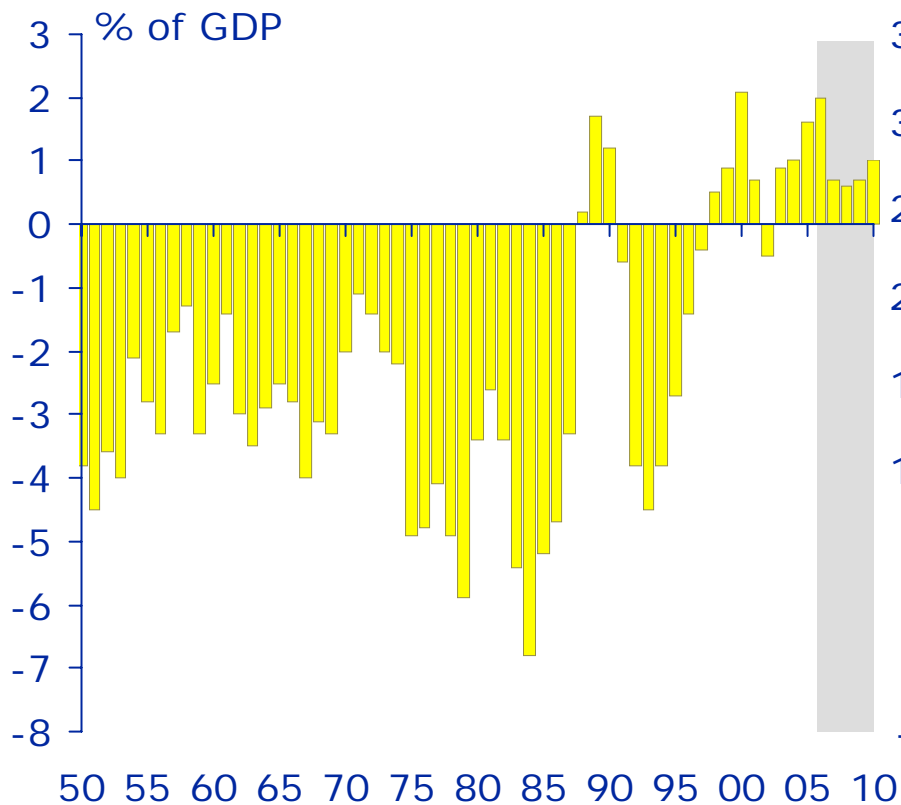
Australian sharemarket



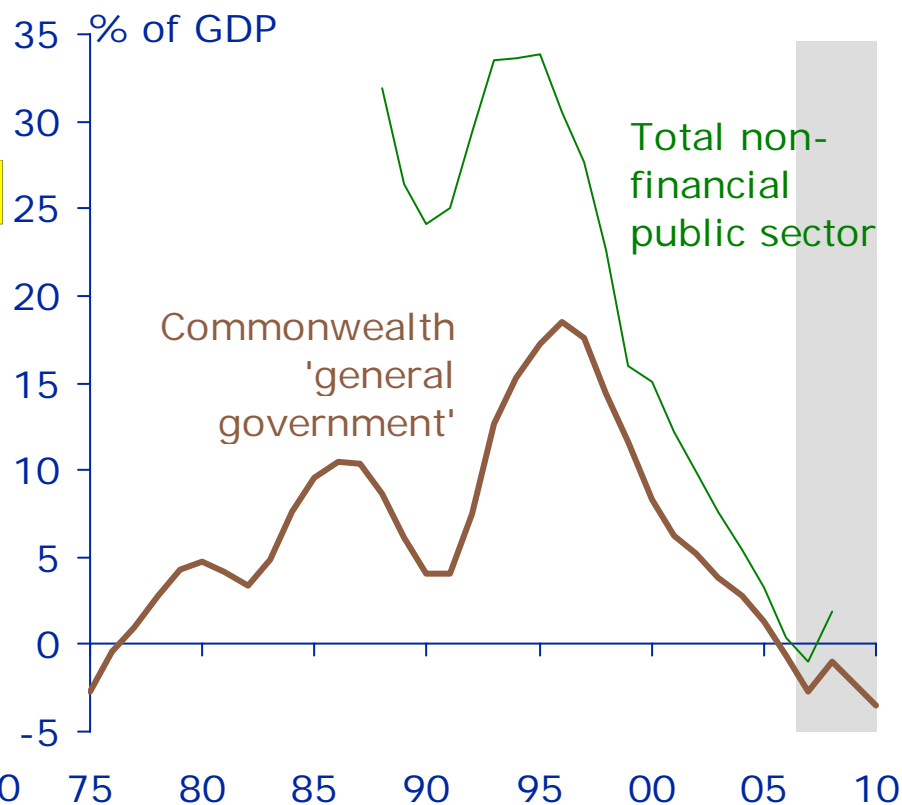
Sources: Australian Bureau of Statistics; Australian Stock Exchange; Thomson Financial Datastream.

Australian public sector finances are among the strongest in the developed world

'General government' cash balance



Public sector net debt



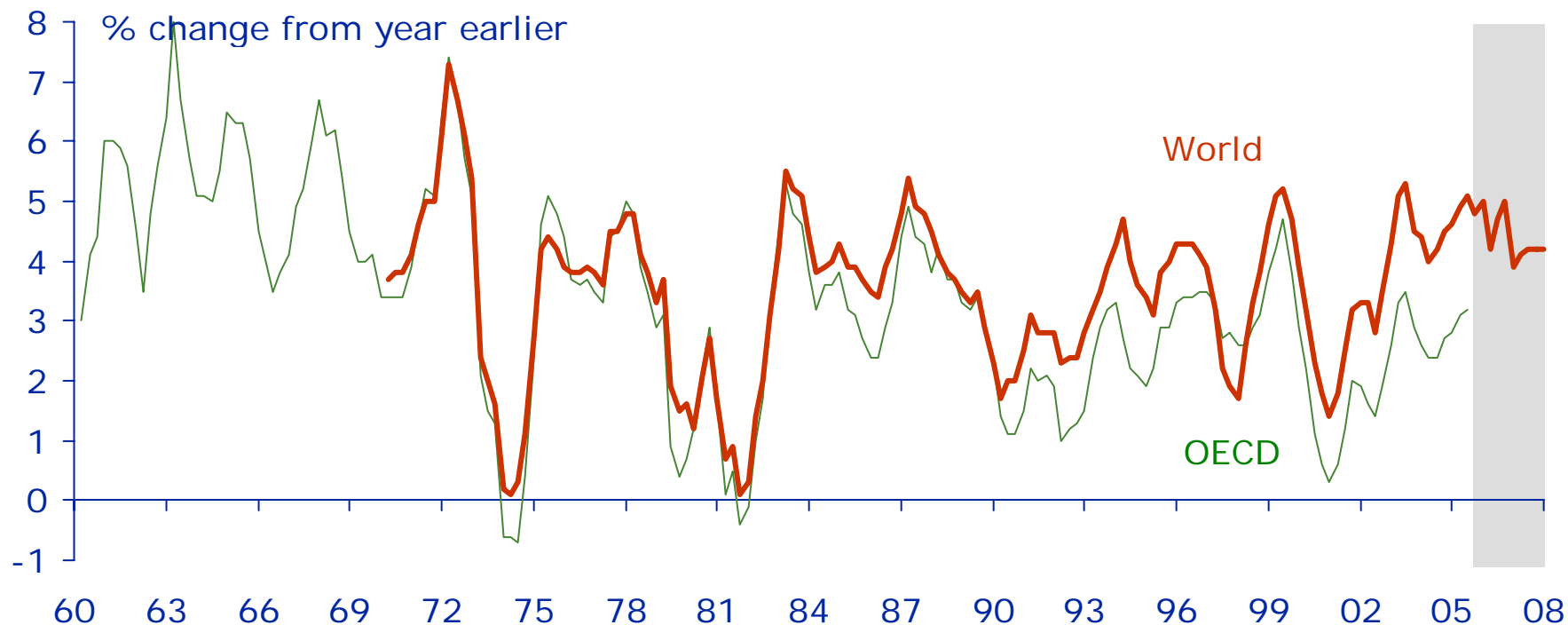
Note: Shaded areas denote official forecasts. Figures are for financial years ended 30th June.

Sources: 2007-08 Commonwealth Budget Paper No. 1, Statement 12;

Reserve Bank *Statistical Bulletin*.

Global economic growth has been stronger and less volatile since the early 1990s

Global real GDP growth

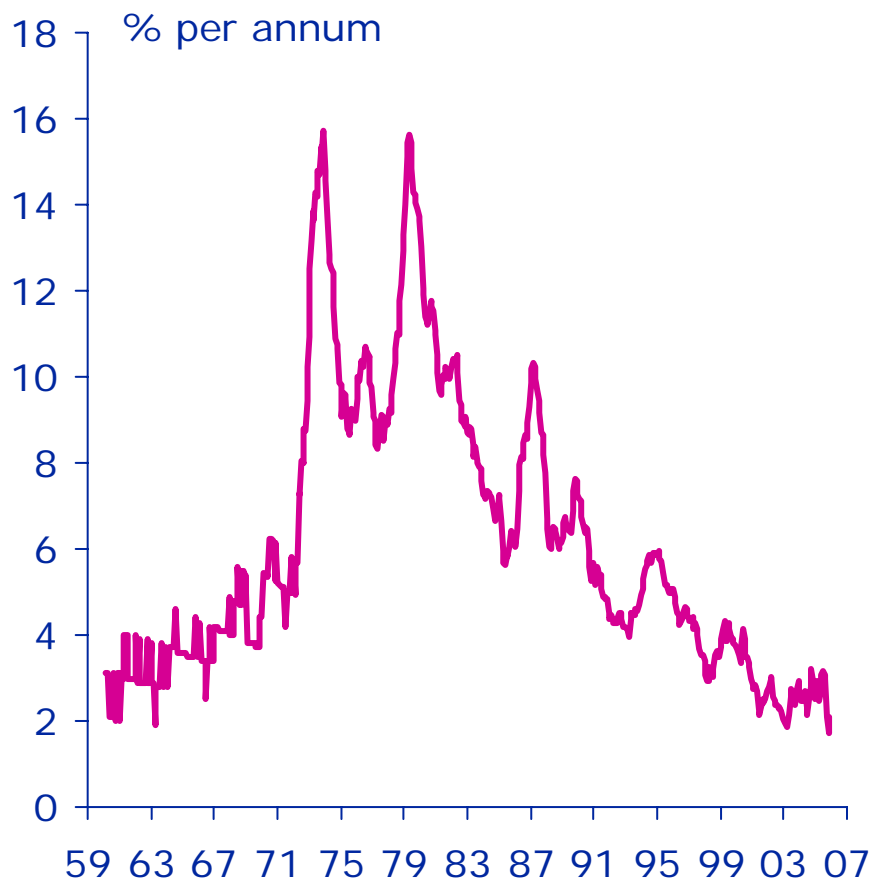


	Mean (% pa)				Standard deviation (pc pts)			
	1970s	1980s	1990s	2000s	1970s	1980s	1990s	2000s
OECD	3.4	3.0	2.6	1.8	2.0	1.4	0.9	0.9
World	2.9	2.8	3.2	3.4	1.7	1.4	1.0	1.2

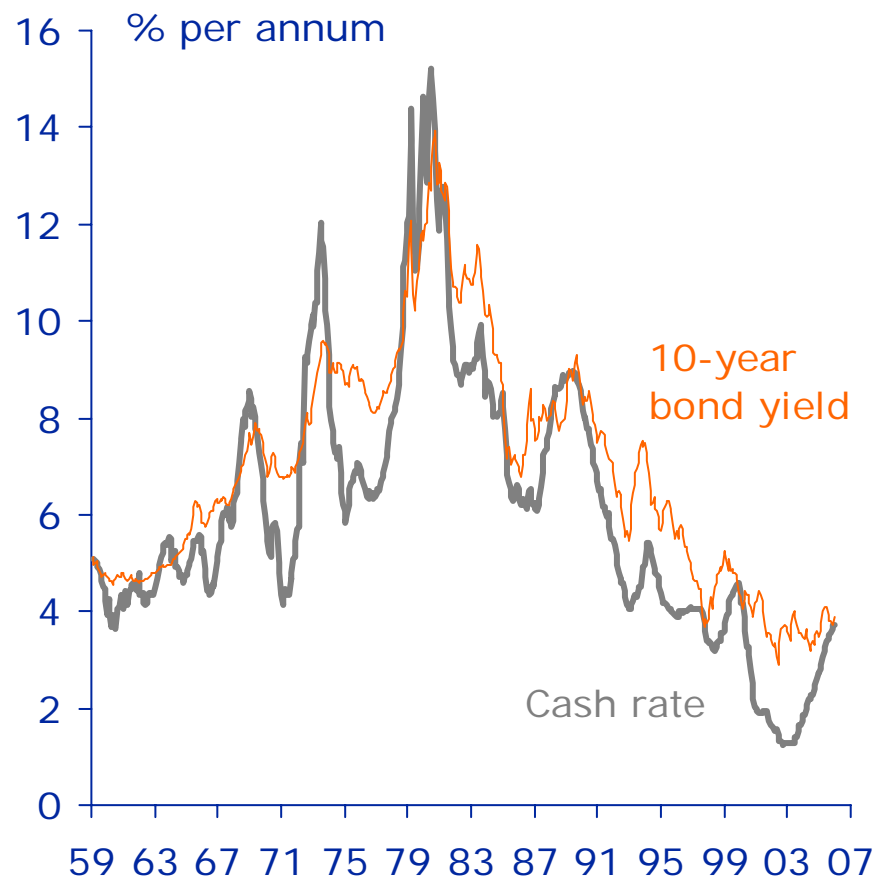
Sources: OECD; national statistical agencies and central banks; Thomson Financial Datastream; Economics@ANZ.

Inflation and interest rates have fallen around the world since 1990, not just in Australia

OECD inflation



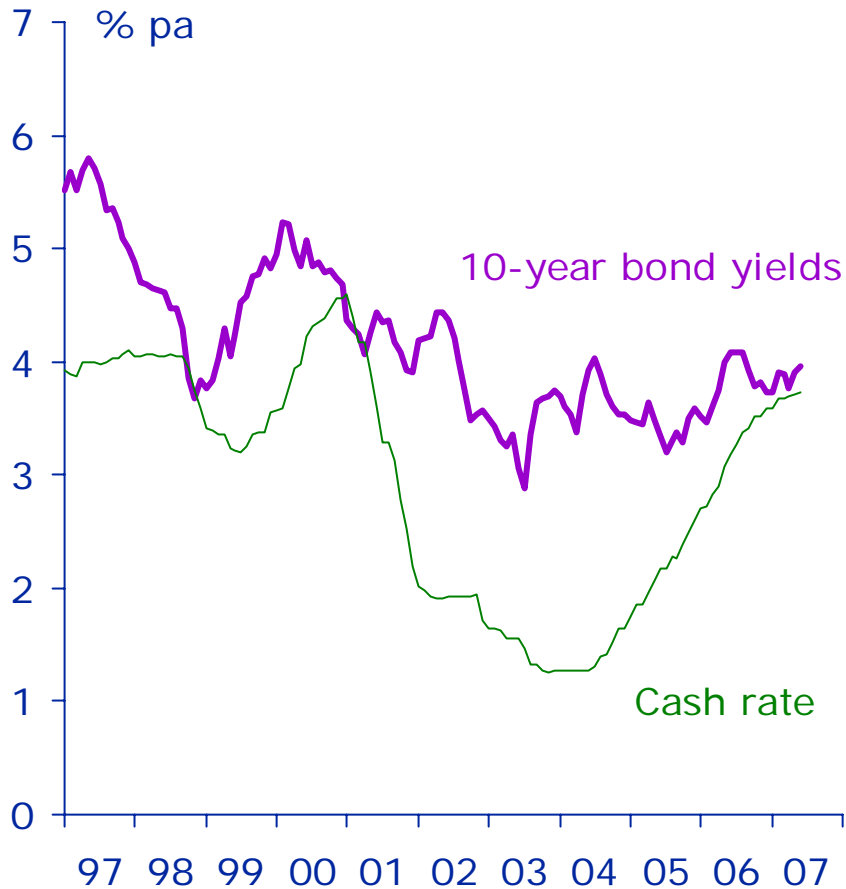
'G7' interest rates



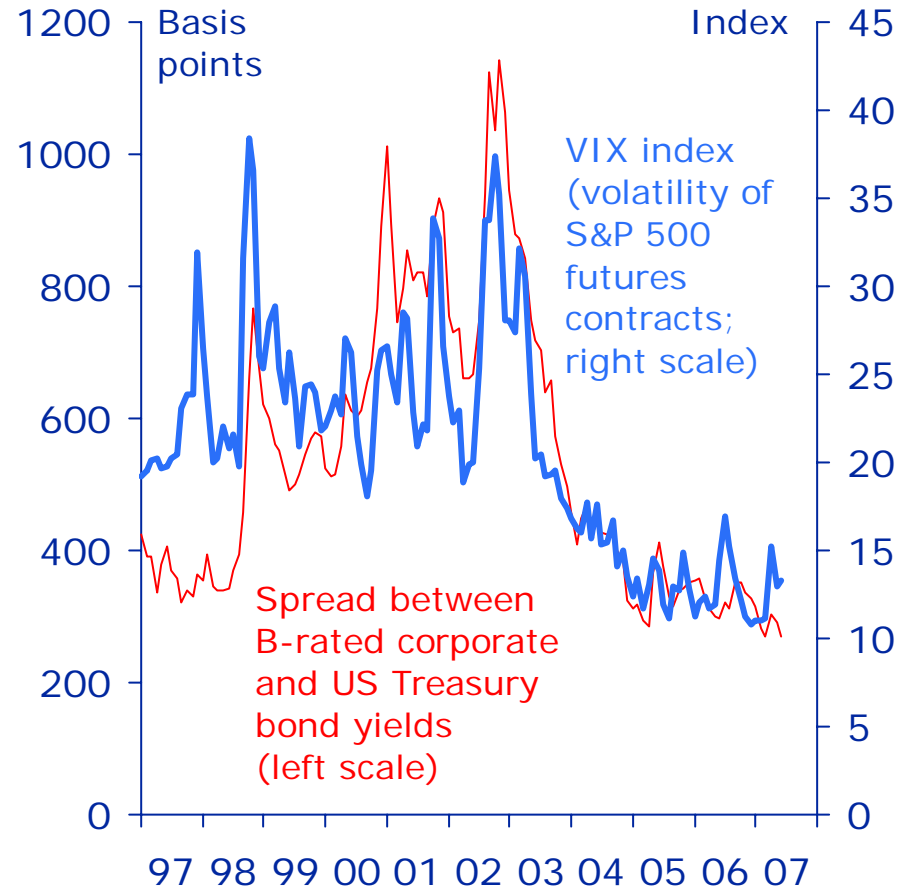
Note: G7 cash rate excludes France before January 1964; G7 bond yield excludes Japan before May 1966.
Sources: OECD; national central banks; Thomson Financial Datastream; Economics@ANZ.

These capital flows are helping to keep long-term rates low and boosting investors' appetite for risk

G7 interest rates



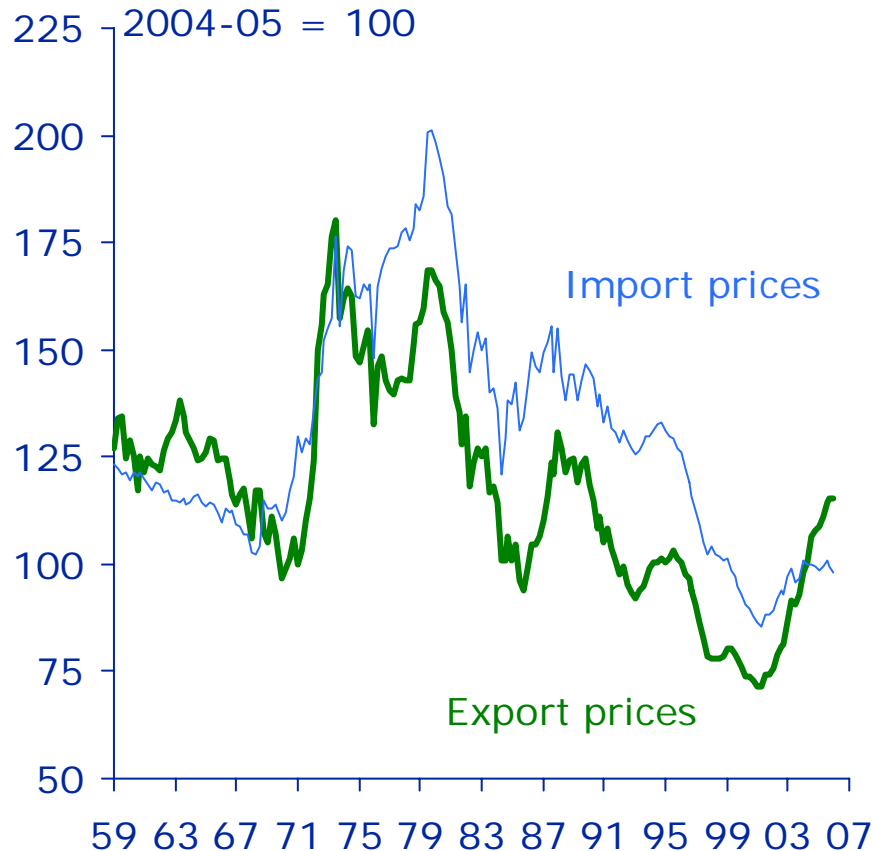
Indicators of investors' appetite for risk



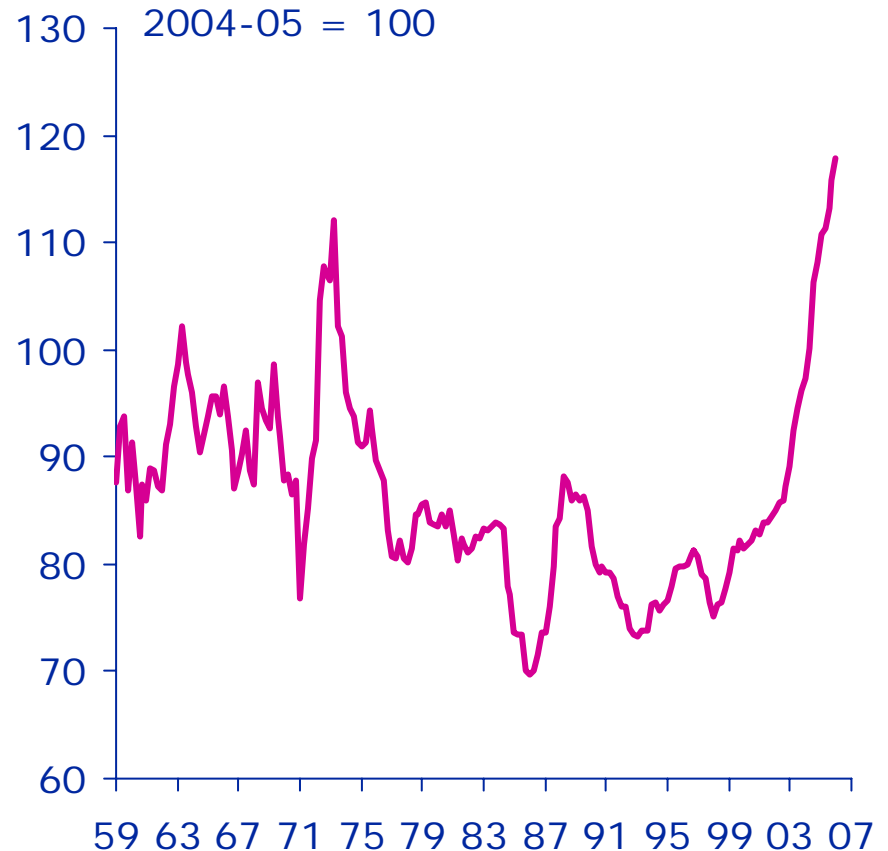
Source: Thomson Financial Datastream.

Australia's terms of trade have improved since the early 90s, reversing the decline of the 70s and 80s

Australian export and import prices in real US\$ terms



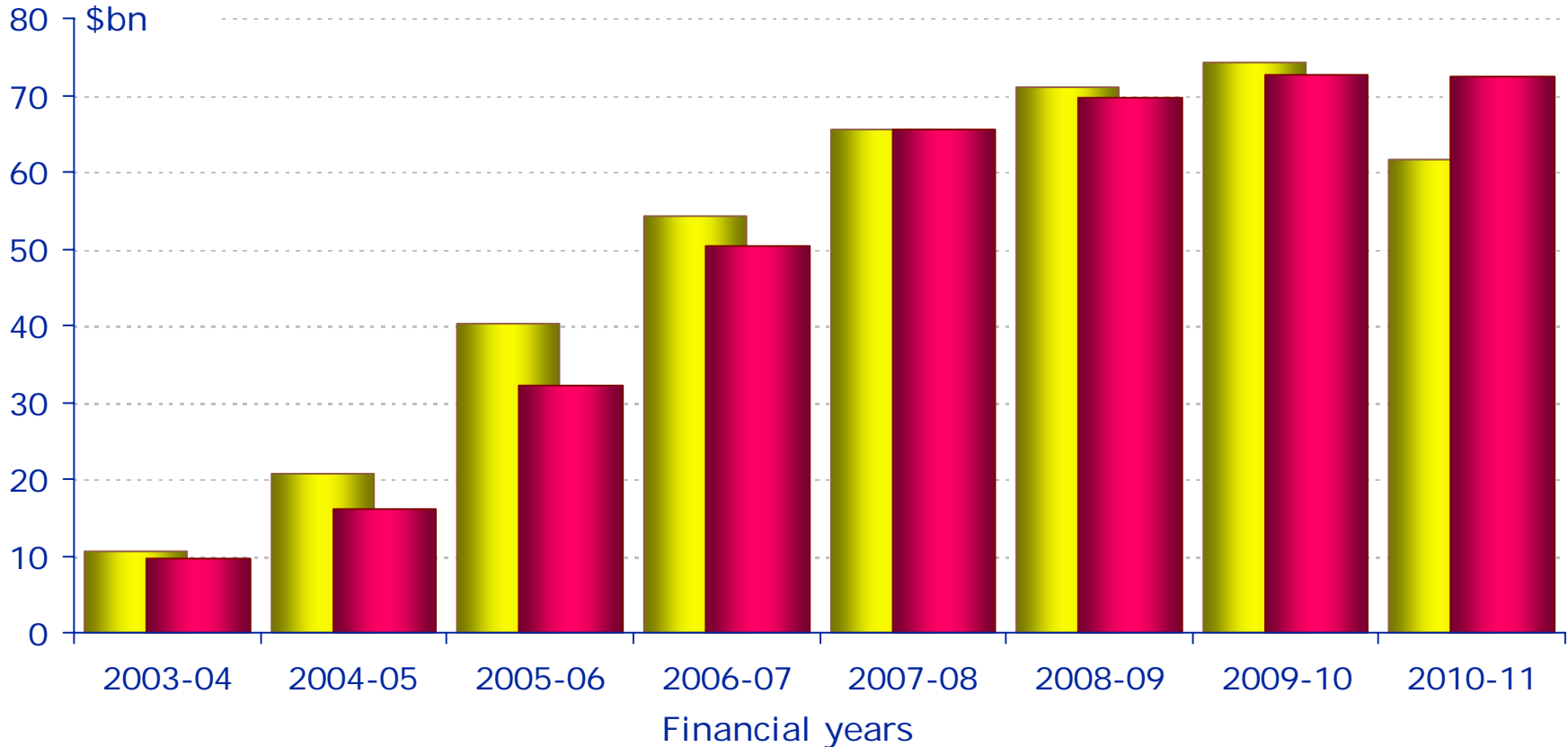
Australia's 'terms of trade'



Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Economics@ANZ.

Over the past 5 Budgets, 'parameter variations' total \$398 bn and policy decisions \$388bn

Cumulative net impact on the 'underlying' cash balance of 'parameter variations' and 'policy decisions' over past 5 Budgets

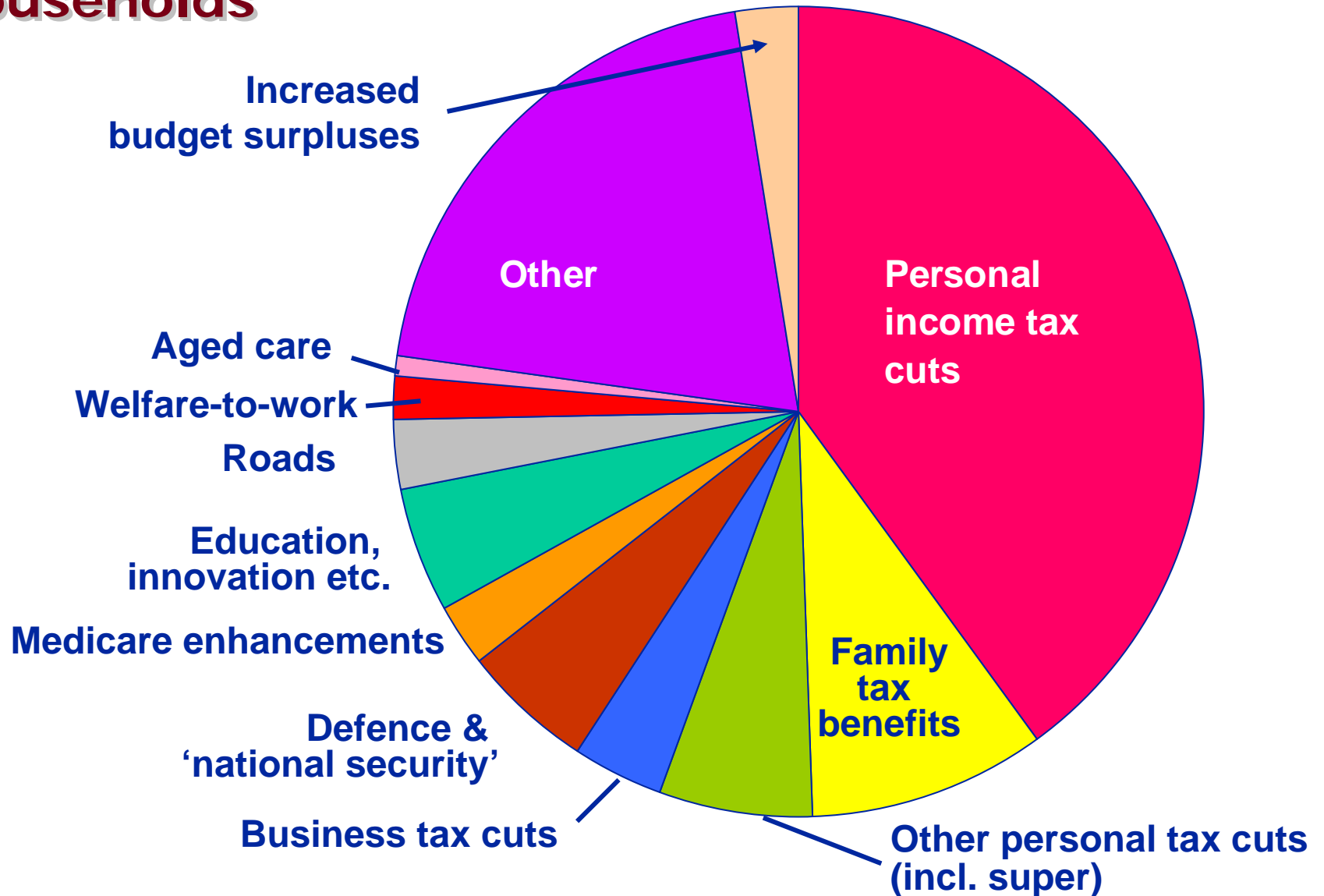


Cumulative impact of: ■ 'Parameter variations' ■ 'Policy decisions'

Source: Table 4, Statement No. 1 in *Budget Paper No. 1* (various years); Economics@ANZ.

See footnote on previous slide for explanation of assumptions used in compiling estimates.

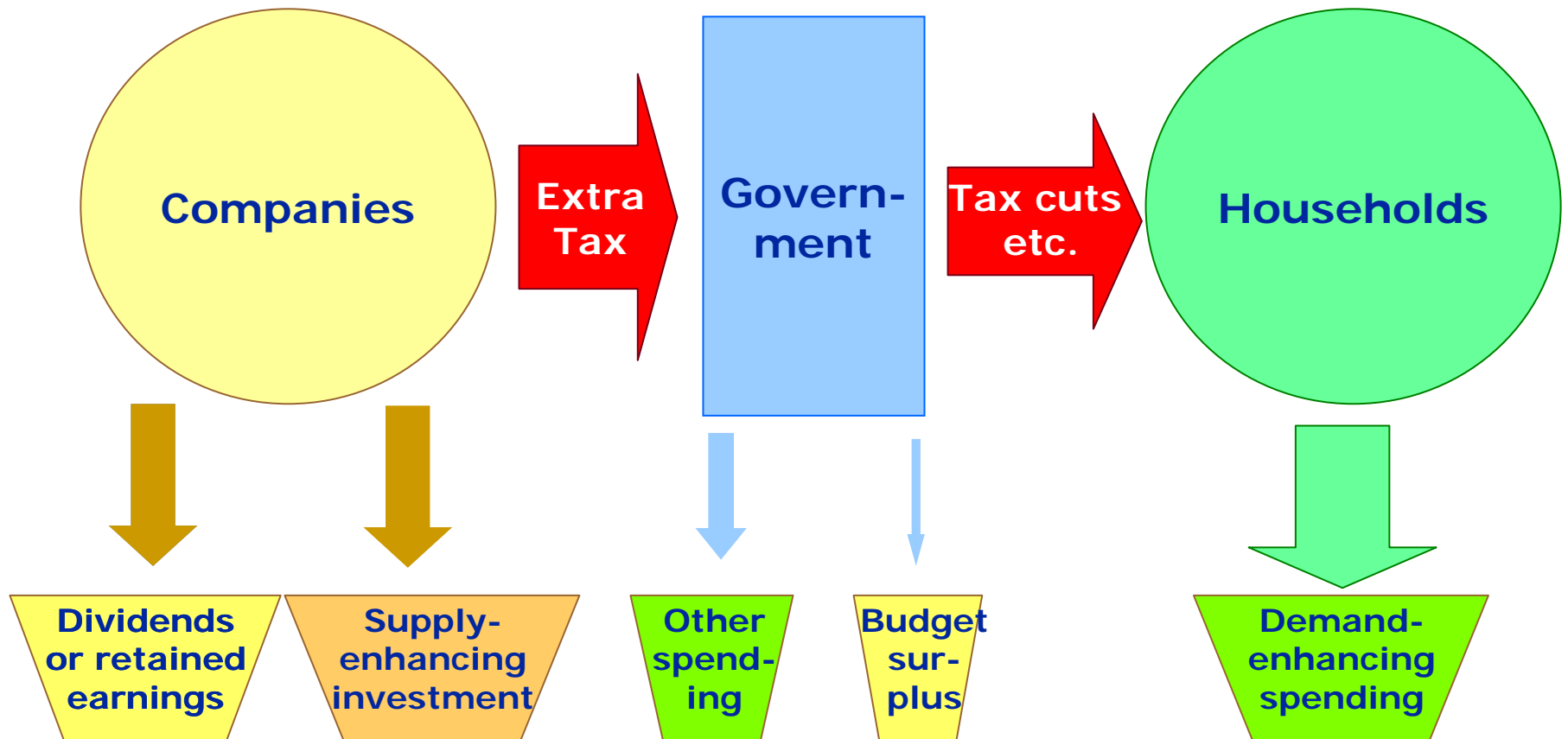
56% of this has been handed over in cash to households



Sources: As for previous slide. Total is A\$398bn over nine years.

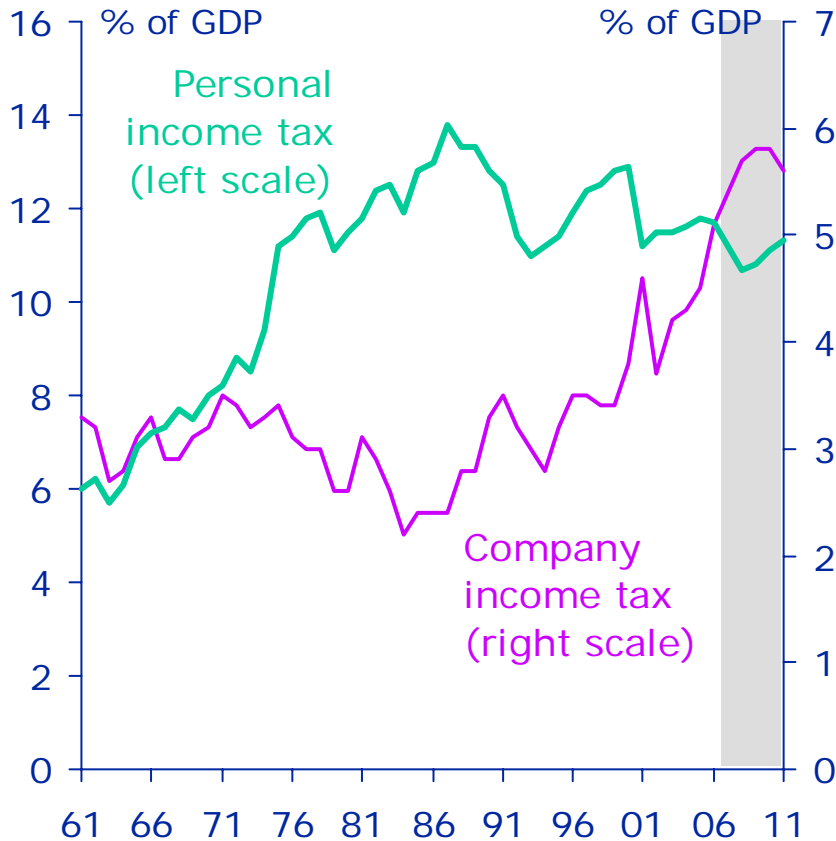
Just because the Budget is in surplus doesn't mean it's not boosting demand

A stylized representation of how the Budget boosts demand even with an unchanged surplus

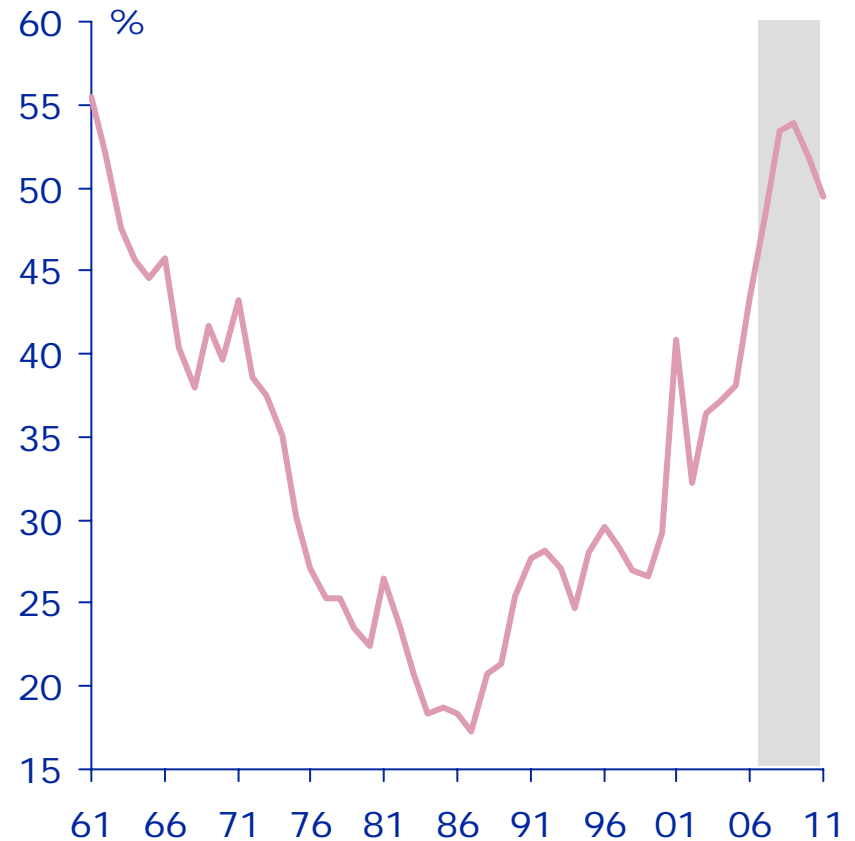


Successive Budgets have effectively redistributed income from companies to households

Personal and company income tax as a % of GDP



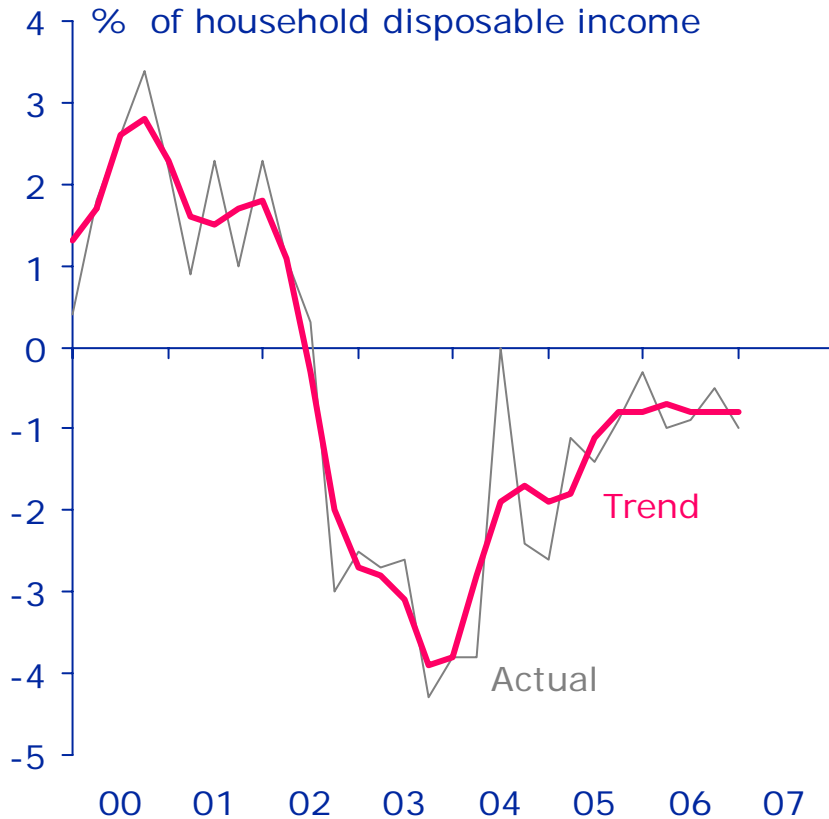
Company income tax as a % of personal income tax



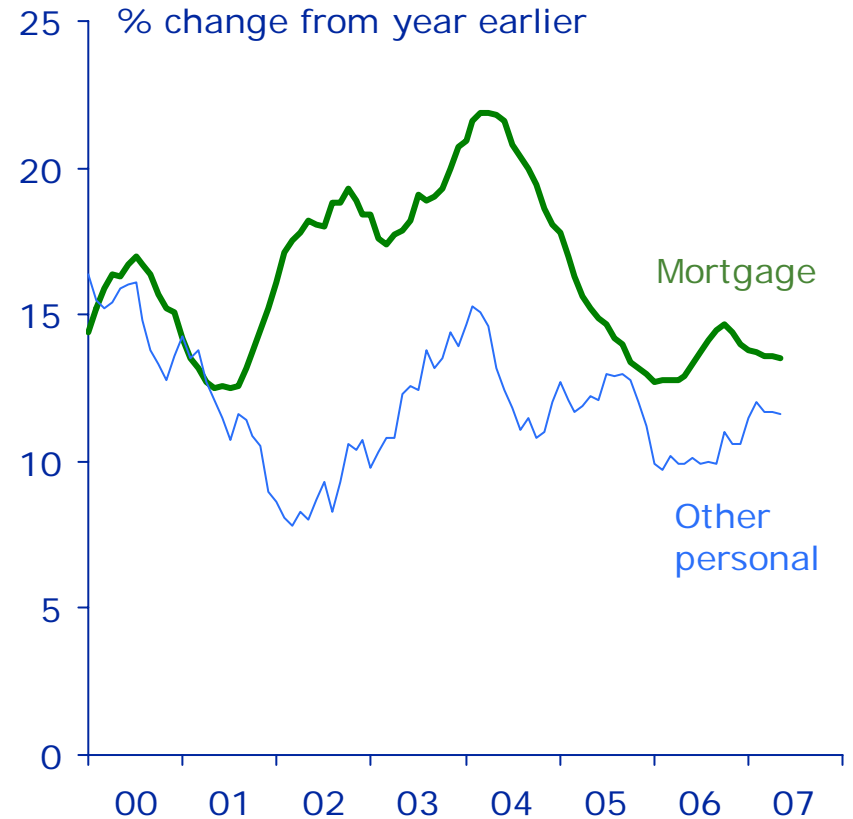
Sources: RBA Occasional Paper No 8, *Australian Economic Statistics 1949-50 to 1994-95* Table 2.17 and Budget Paper No. 1, Statement 5, Tables C4 & C5 (various years).

There's no hard evidence that households saved any significant proportion of last year's tax cuts

Household saving ratio



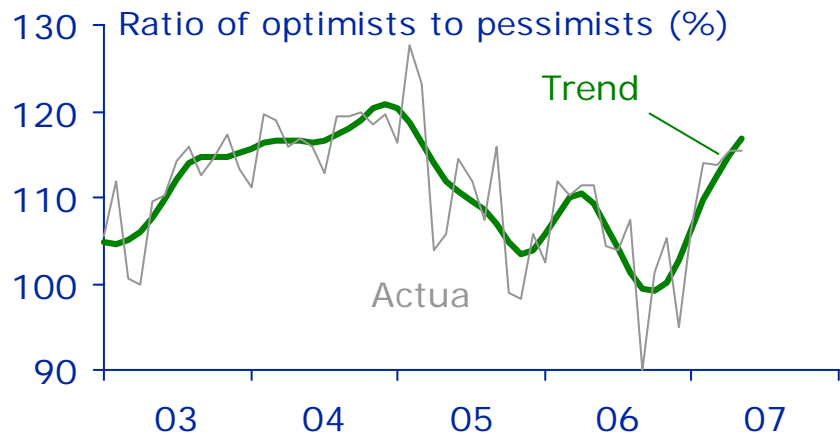
Household credit outstanding



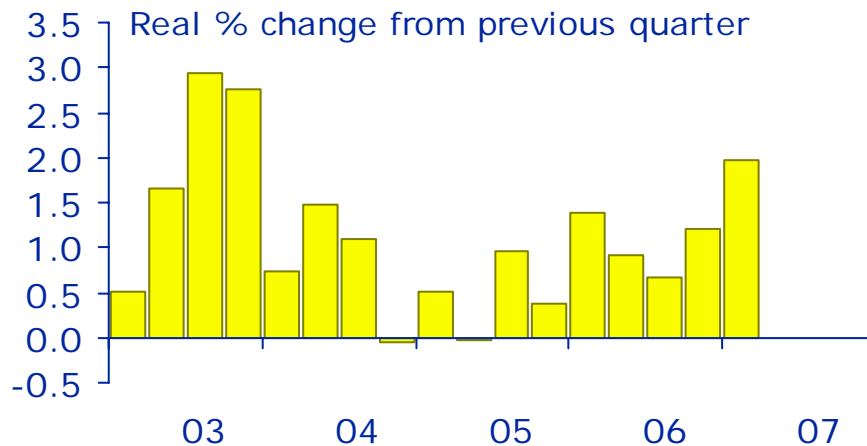
Sources: ABS; RBA.

The three interest rate rises since last May have been offset by the tax cuts and other hand-outs

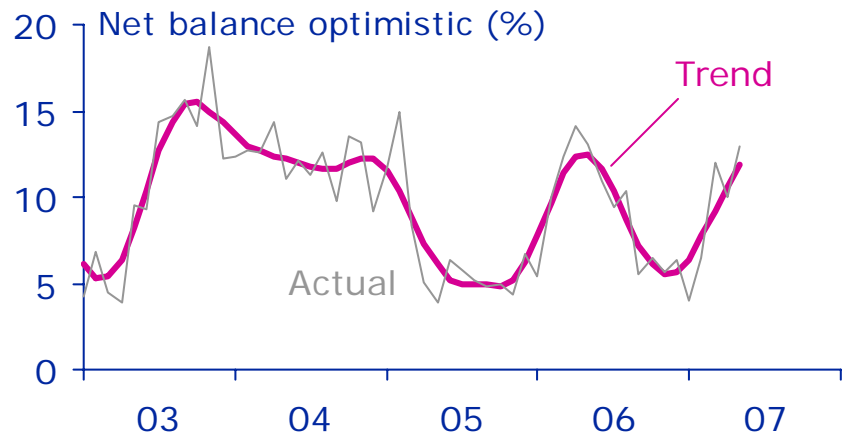
Consumer confidence



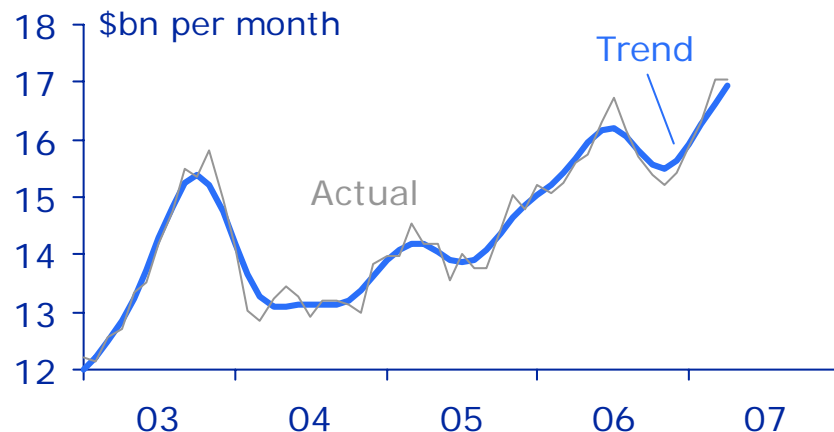
Retail sales volume



Business confidence



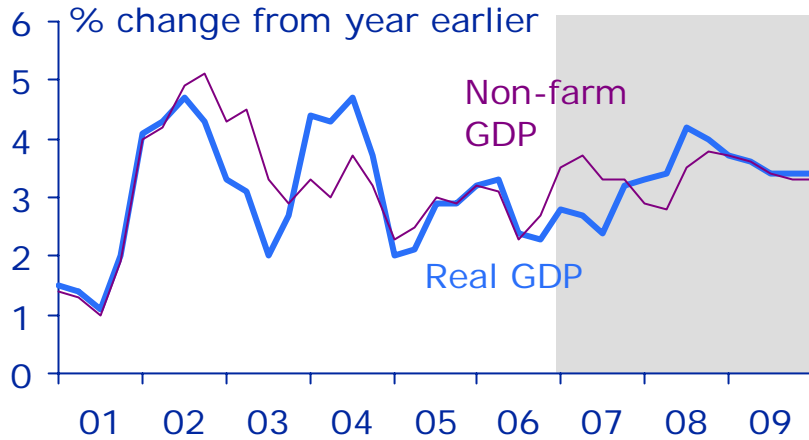
Housing finance commitments



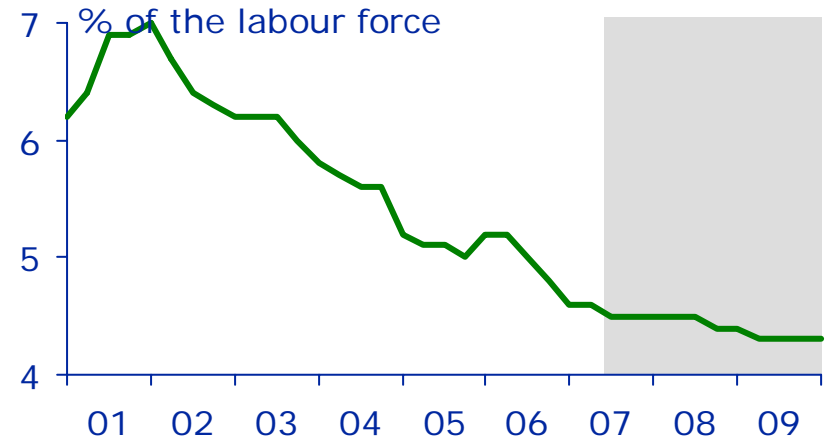
Sources: Westpac-Melbourne Institute; National Australia Bank; ABS.

Economic and employment growth will remain strong – but inflation is also likely to pick up

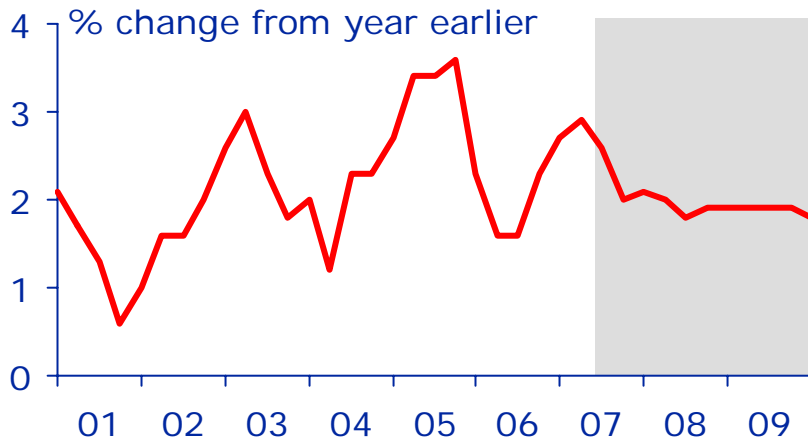
Real GDP growth



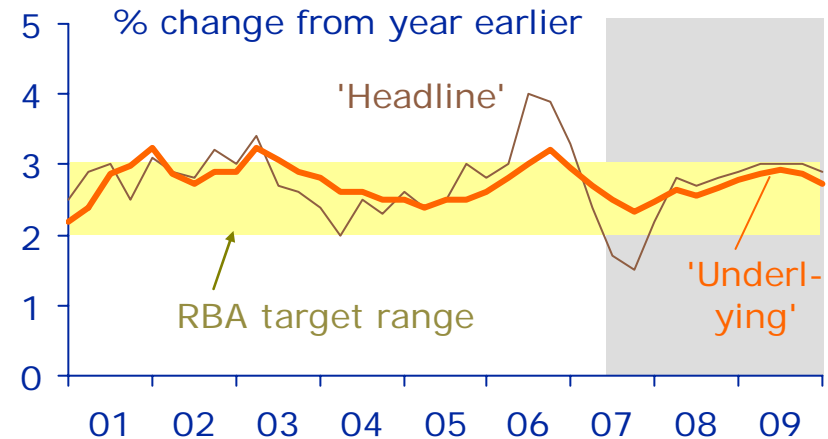
Unemployment



Employment



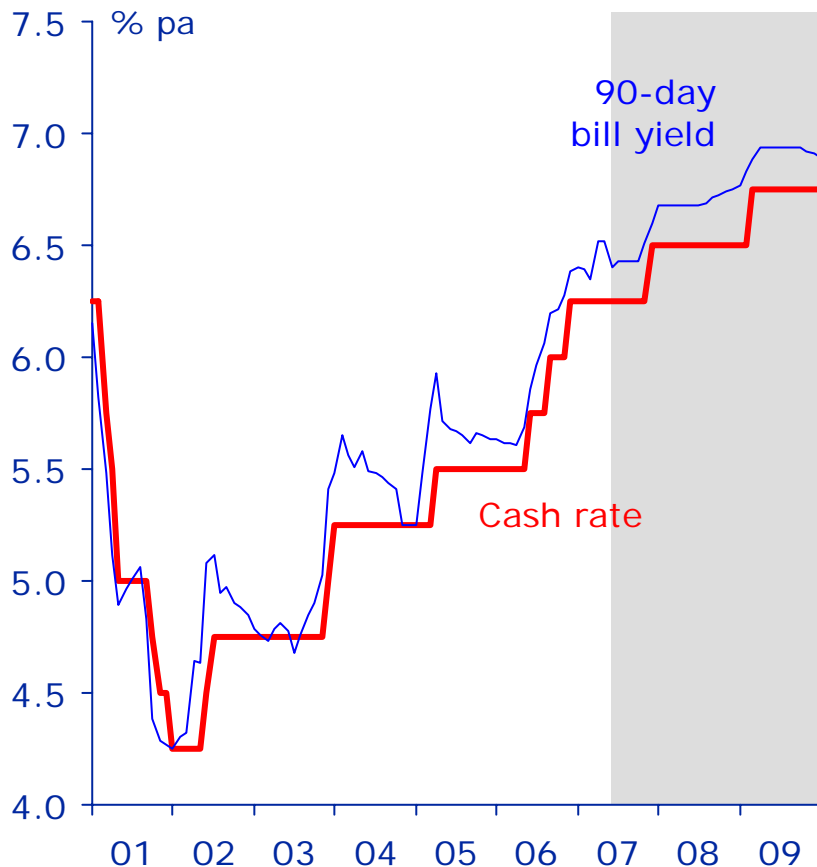
Inflation



Sources: ABS; Economics@ANZ.

Interest rates probably won't rise before the election but will go up again afterwards

Australian interest rates



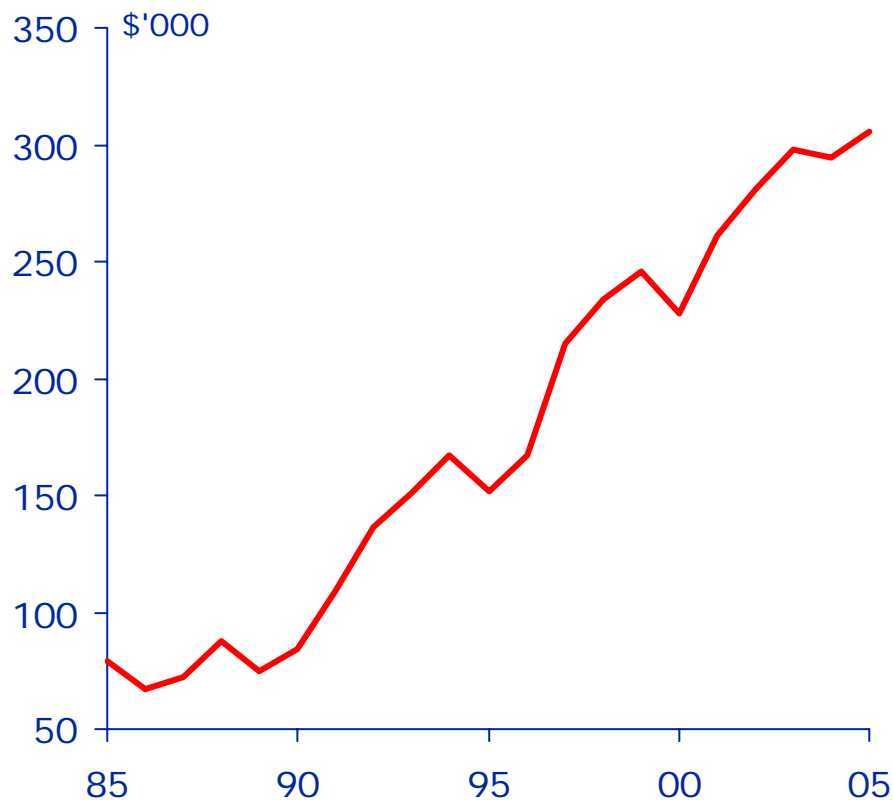
Shaded areas denote forecasts.

Sources: RBA; Datastream; Economics@ANZ.

- The RBA gave strong hints that it was contemplating a rate increase in April but chose to wait for the March quarter inflation data – which vindicated the decision to remain on hold
- Having lowered its forecast for 'underlying inflation' for 2007 to 2½% the RBA is quite unlikely to raise the cash rate in the next six months (ie before the election)
- But its forecasts for 2008 and beyond signal an on-going concern that 'underlying' inflation could exceed the top of the target band – and with demand set to remain strong a post-election rate rise is likely

Higher house prices largely reflect falling interest rates and rising incomes ...

Maximum borrowing by couple earning average male and female earnings, repayments capped at 25% of gross income and 20% deposit



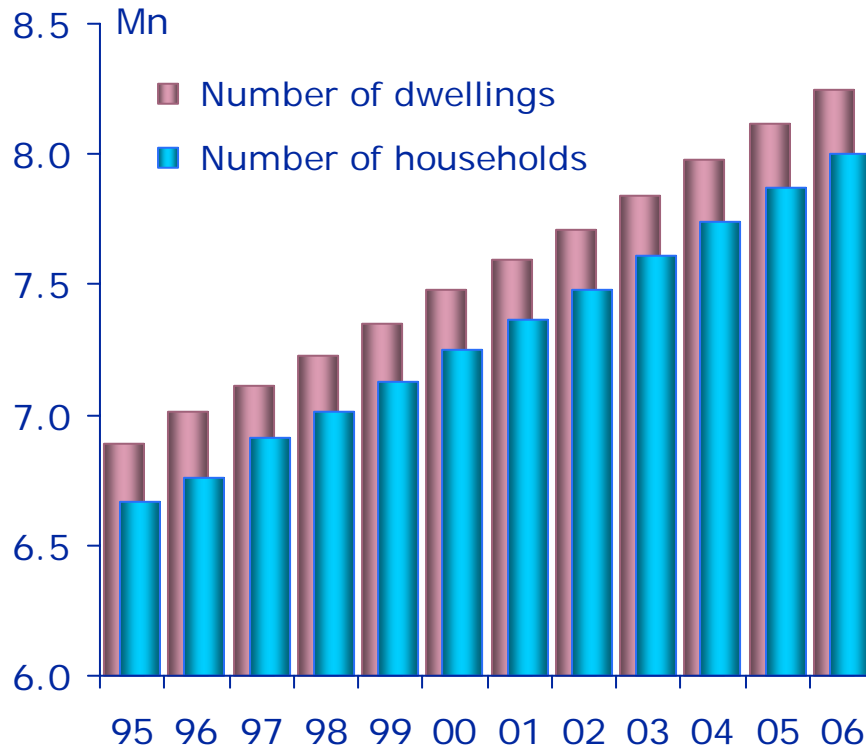
Note: data are for the June quarter each year.

Sources: ABS; Economics@ANZ.

- Since the early 1990s, average earnings have risen by over 60% while the standard variable mortgage rate has halved
- This has increased the maximum amount which a 'typical couple' can afford to borrow under standard lenders' rules from around \$135 000 in 1992 to \$305 000 in 2006
- In practice the rates actually paid by borrowers have fallen by more than the standard variable rate, while the traditional 'rules' are much less rigorously applied

... combined with faster growth in 'underlying demand' than in supply

Number of households and number of dwellings



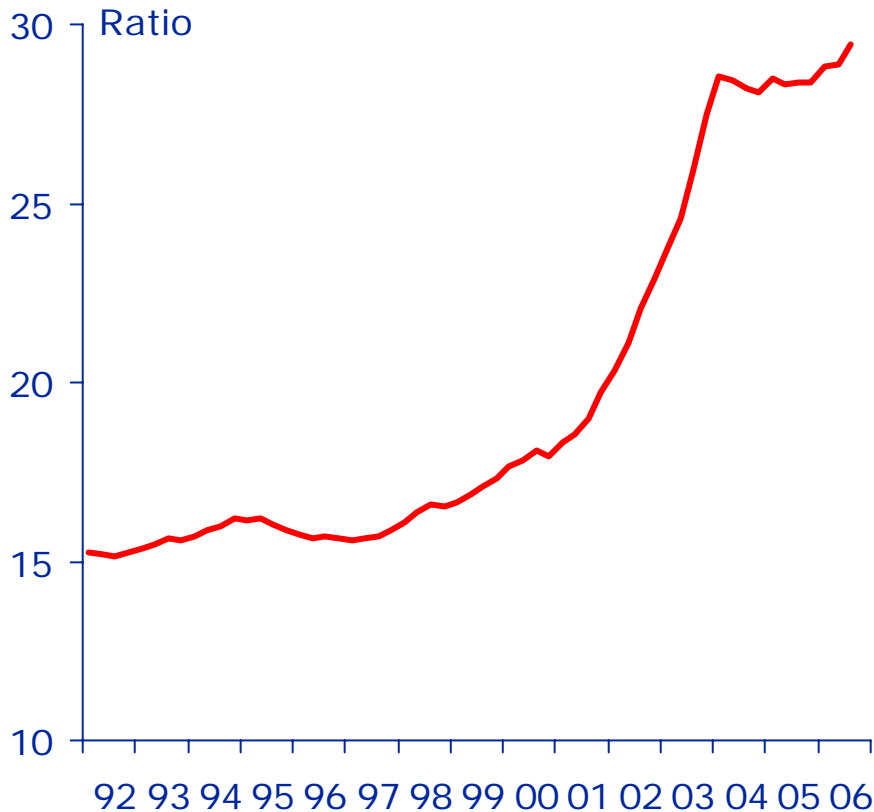
Note: Dwelling stock estimates for 1991, 1996 and 2001 based on census figures; other years interpolated using completions data.

Sources: RBA; ABS; Economics@ANZ.

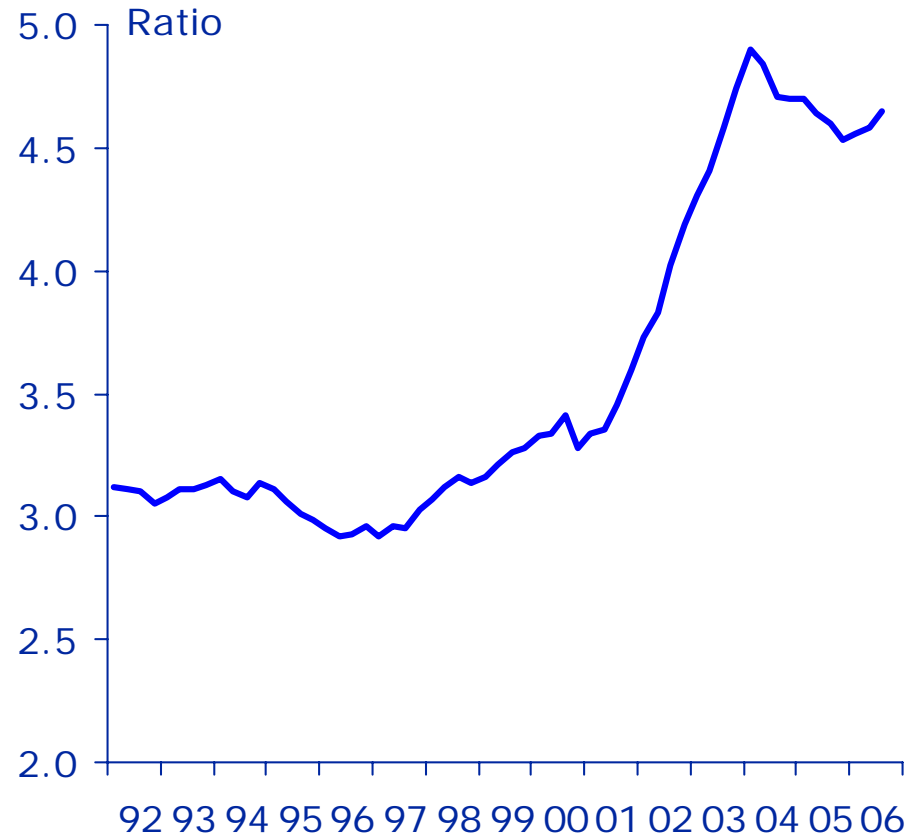
- Over the ten years to June 2006, the stock of housing increased by 1.24 million
 - 1.46 mn new dwellings were completed during this period, but around 222,000 old dwellings were demolished
- Over the same period, the number of households rose by exactly the same 1.24 million or 18%
 - faster than the increase in population (12.7%) because of falling average household size
- The increase in the supply of housing was thus entirely absorbed by increased demand

Although Australian houses may appear to be 'over-valued' relative to rents or incomes

Ratio of median house prices to median rents



Ratio of median house prices to average household incomes



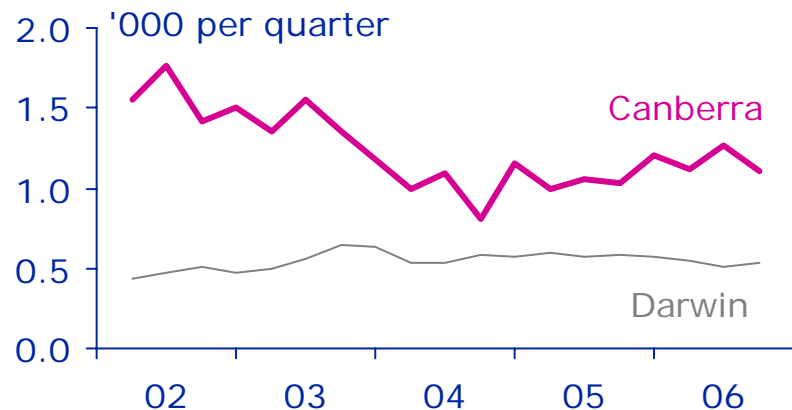
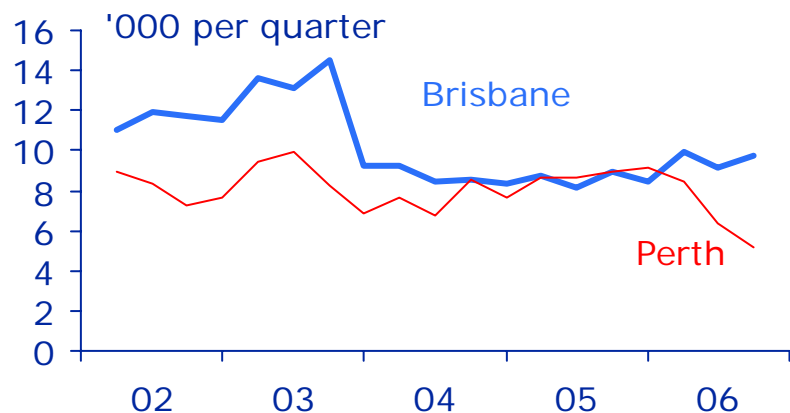
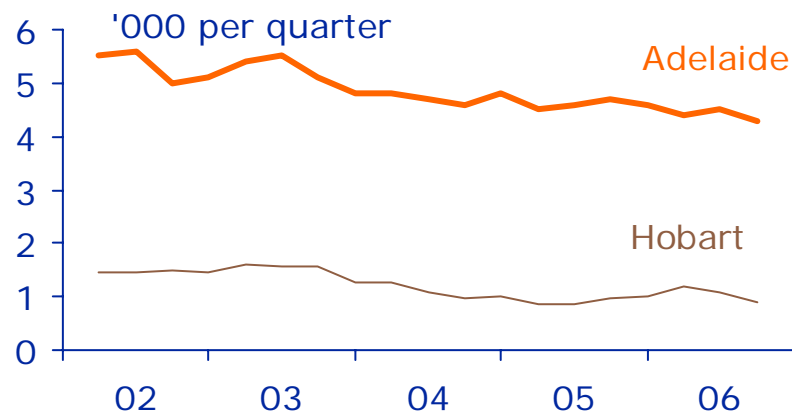
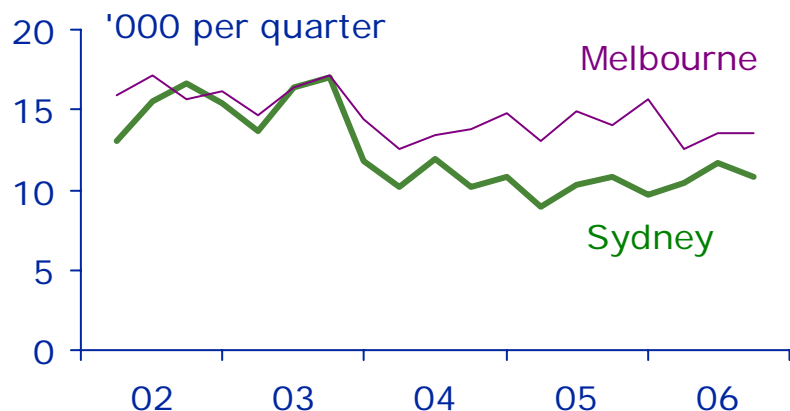
Sources: ABS; REIA, Economics@ANZ.

... that does *not* mean that house prices must inevitably fall

- Housing market pessimists point to the (undeniable) fact that Australian house prices are now at record highs relative to incomes or rents
 - and use that to argue that, just as falls in share prices are often preceded by periods in which price-earnings ratios have been unusually high, high ratios of house prices to incomes or rents mean that house prices must 'inevitably' fall sharply
- This line of reasoning ignores a fundamental difference between the share and residential property markets
 - no-one has a 'natural long' position in the share market
 - but in cultures where home ownership is strongly preferred (such as Australia), the household sector does have a 'natural long' position in the residential property market
- ... which means that as long as interest rates remain at reasonable levels – so that currently marginal owners do not become forced sellers – people will not sell houses simply because houses appear 'over-valued'
- Rather, they are more likely to 'sit out' a period of stagnant prices

'Turnover' in the established house market has dropped by 30% over the past three years

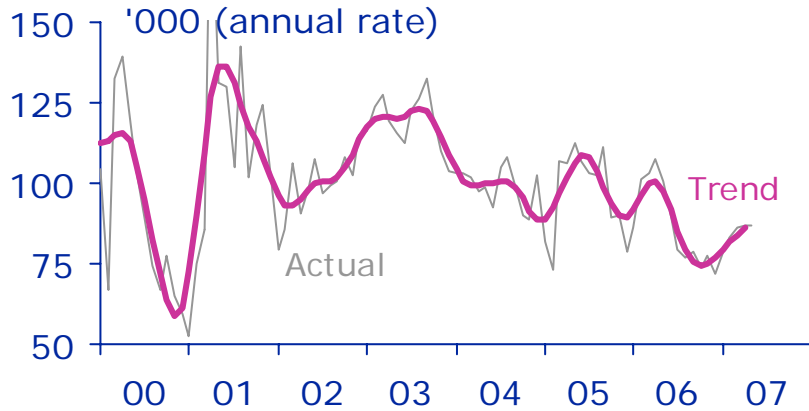
Transactions in established houses



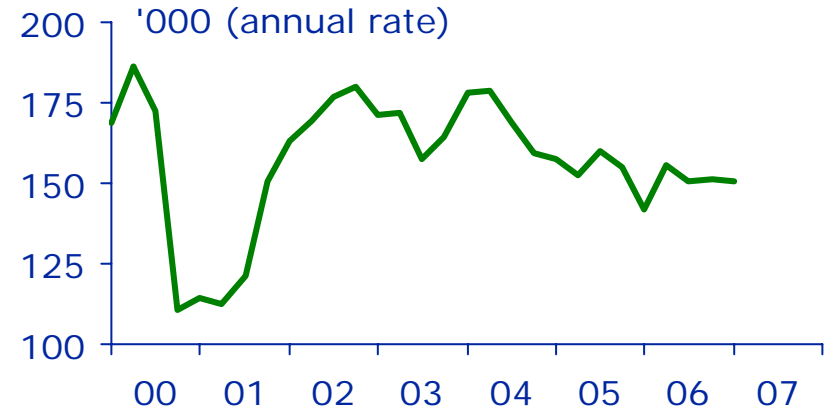
Sources: ABS (house price release); Economics@ANZ.

Net additions to residential supply are falling well short of 'underlying demand'

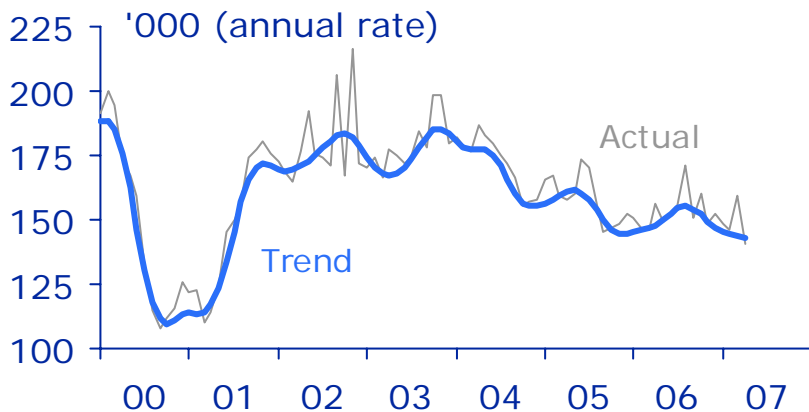
New house sales



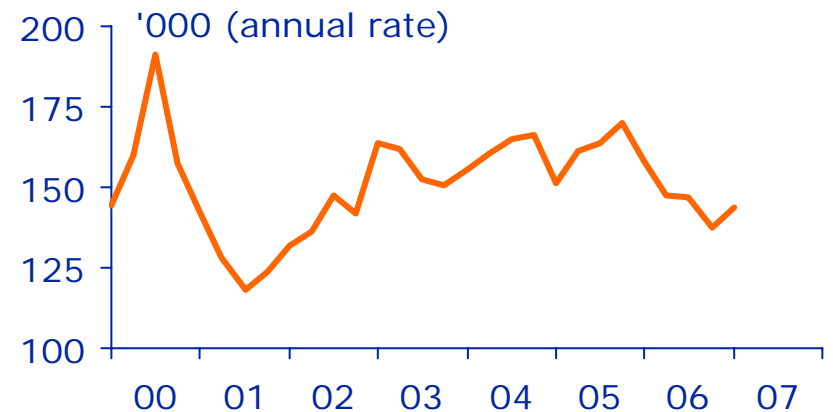
Residential commencements



Residential building approvals

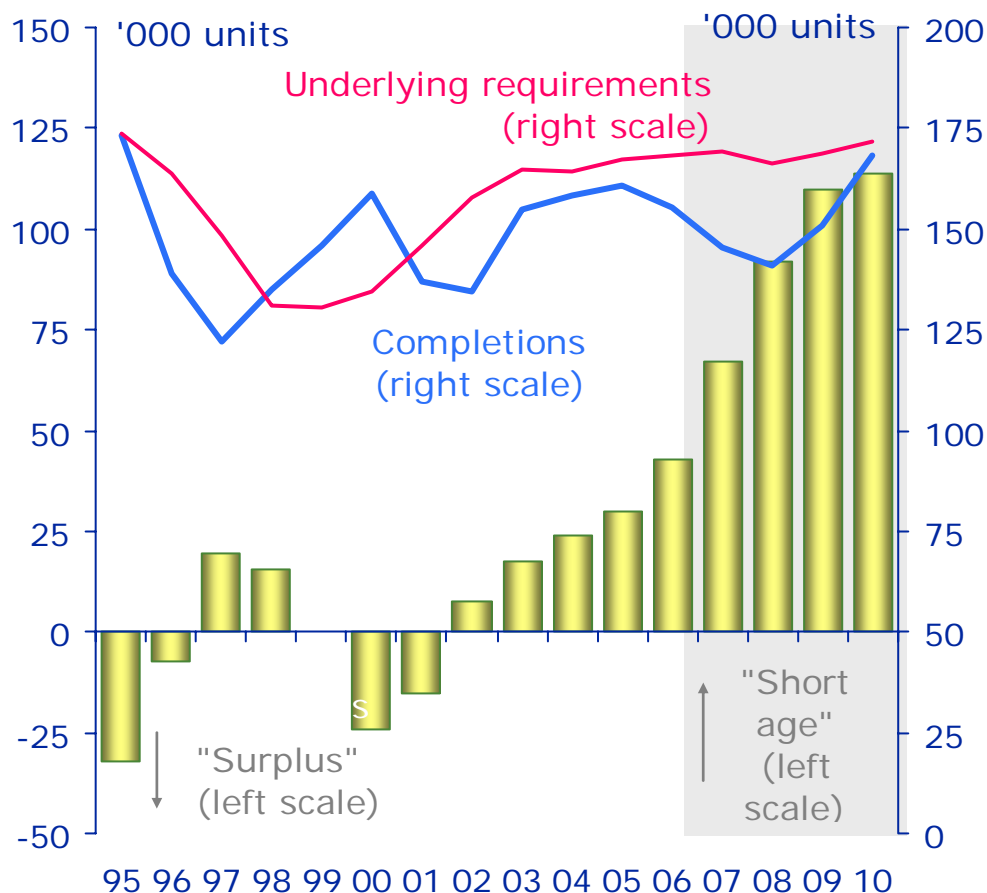


Residential completions



At current construction levels, the shortage of housing is likely to increase sharply

National housing market balance



Note: 'Surplus' or 'shortage' is the cumulative difference between completions and underlying demand from an historical starting point. The direction of movements in this measure is more significant than the level. Sources: ABS; Economics@ANZ.

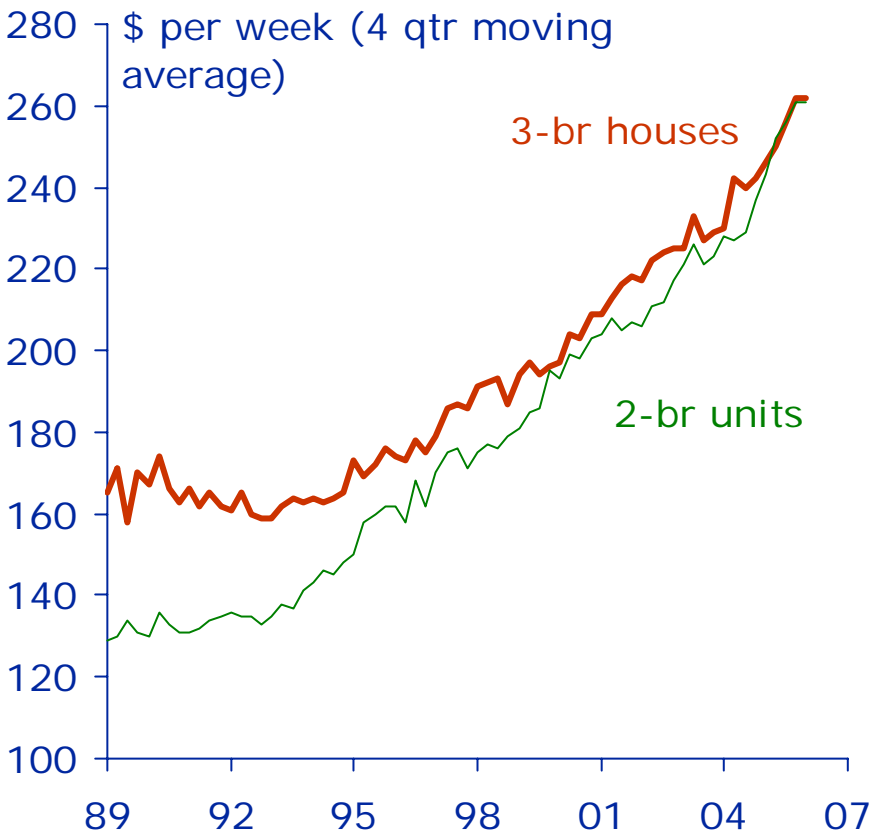
- Underlying demand for housing is running at around 165K units pa, driven by strong immigration and declining average household size
- Completions are likely to fall below 150K pa over the next 3 years
- So a significant shortage of housing is starting to develop
- Commencements need to pick up to over 170K pa to begin making meaningful inroads into this shortage

The 'net shortage' position is also apparent from falling vacancy rates and rising rents

Rental vacancy rate



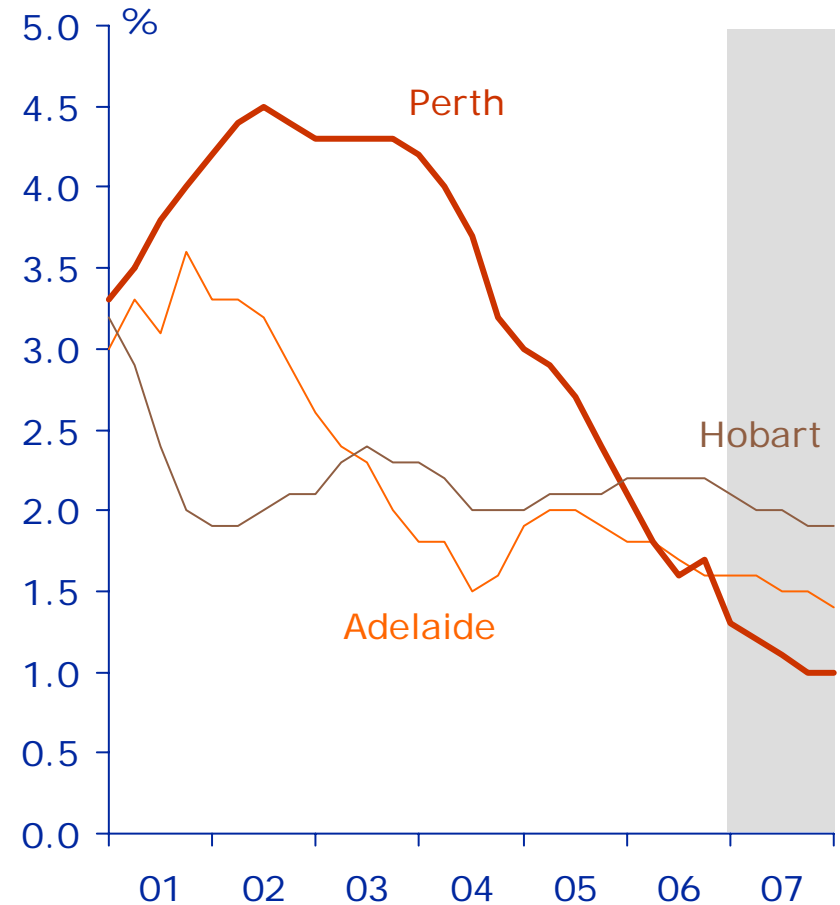
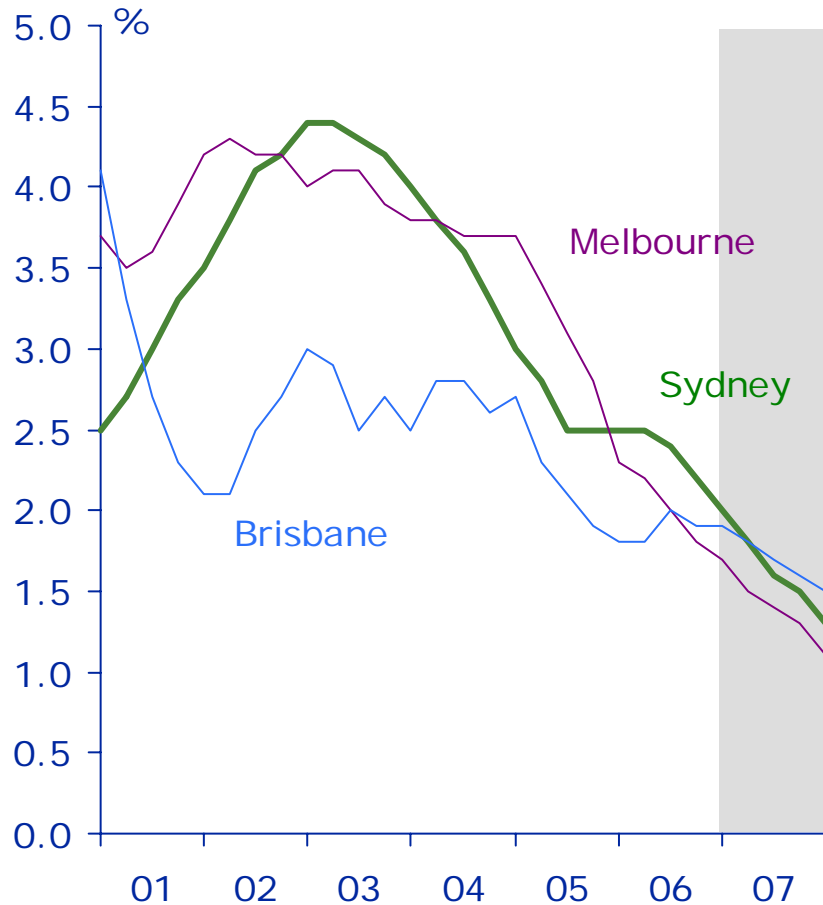
Median rents



Note: data are weighted average of eight capital cities.
Source: REIA.

Rental vacancy rates are likely to be down to critical levels in all capitals by the end of the year

Rental vacancy rates



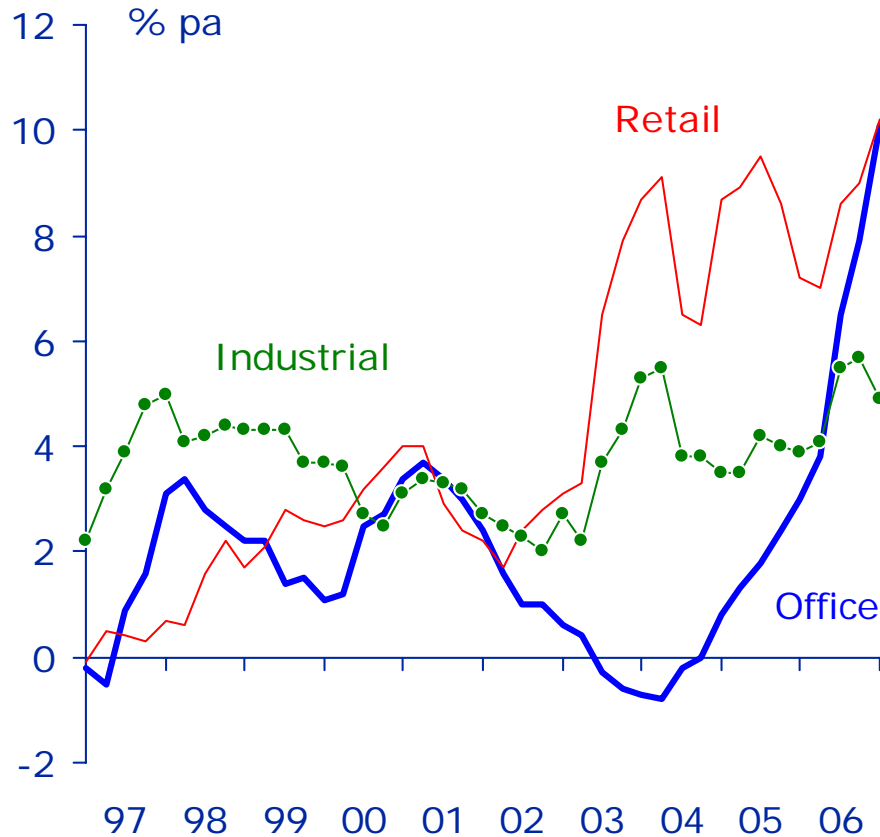
Sources: REIA; Economics@ANZ.

Throwing cash at home-buyers does *nothing* to improve housing affordability

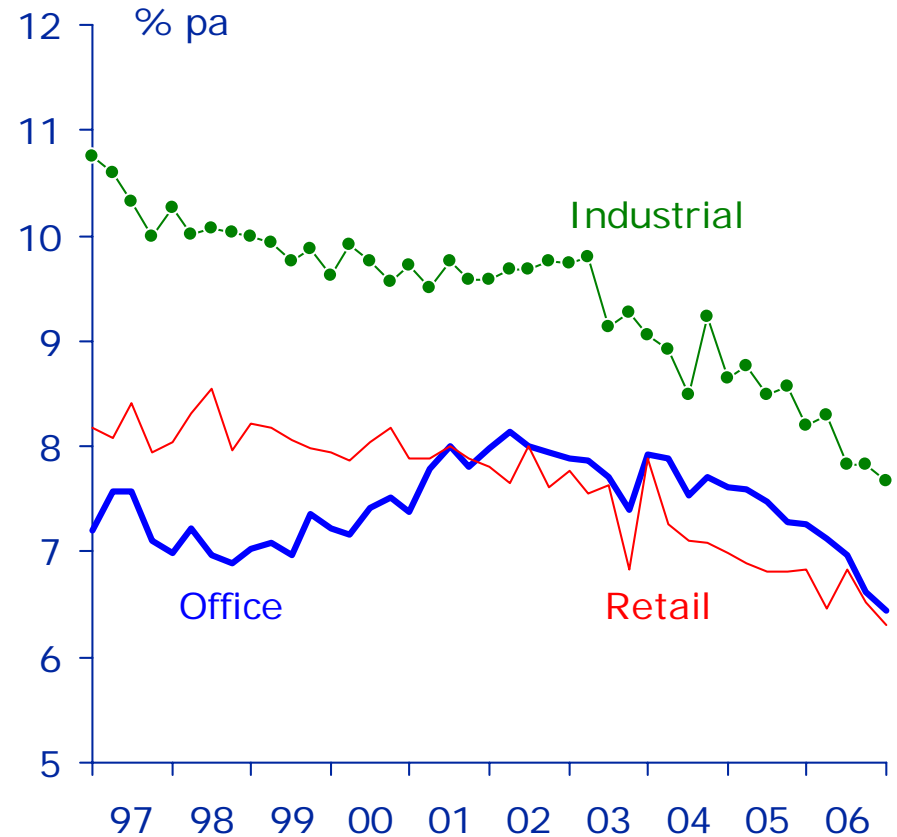
- Housing has become 'unaffordable' to many first time buyers because for many years now demand has exceeded supply
 - yet the standard response of governments to this problem is to throw cash at homebuyers (increased grants, stamp duty concessions)
 - which only serves to boost demand further
- This ignores the overwhelming evidence that anything which enables Australians to buy more expensive housing ultimately results only in ... more expensive housing
- The only sustainable solutions to the housing affordability 'problem' are on the 'supply side'
 - directly adding to the housing stock through new construction
 - enhanced incentives to new private construction
 - reducing up the time taken to bring land to the market
 - removing obstacles to the conversion of existing properties to residential use (or to more concentrated residential use)
- All levels of government could potentially contribute to 'supply-side solutions'

Returns have improved and yields have fallen in commercial property markets in recent years

Commercial property capital returns

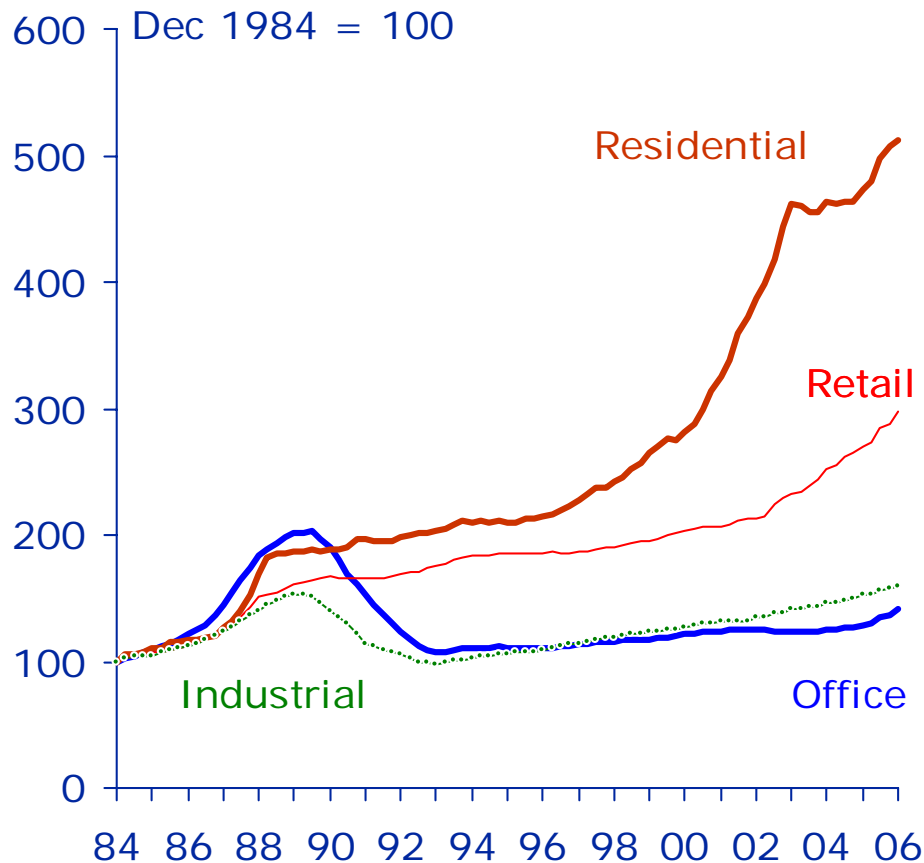


Commercial property capitalization rates



Commercial property values have massively underperformed residential markets

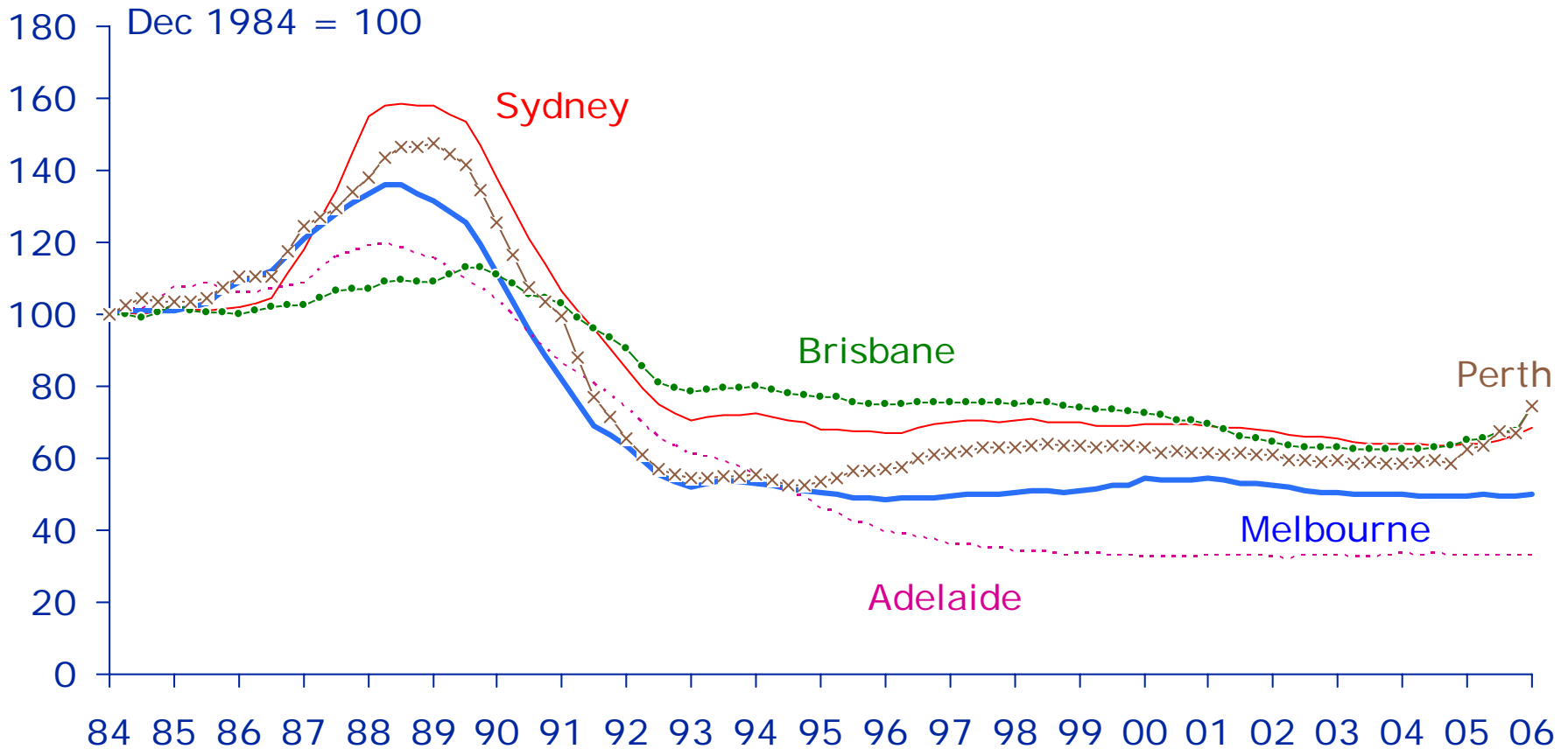
Capital return indices



- Capital values for office and industrial property still haven't recovered from the late 80s / early 90s 'bust'
 - in real terms, office prices are still 37% below 1984 levels, and industrial prices 29% lower
 - by contrast retail property prices have risen 33% in real terms since 1984, and residential 128%
- Poor office and industrial price performance reflects declining real rents
 - since 1985 real office rents have fallen 45%
 - and industrial rents 37%

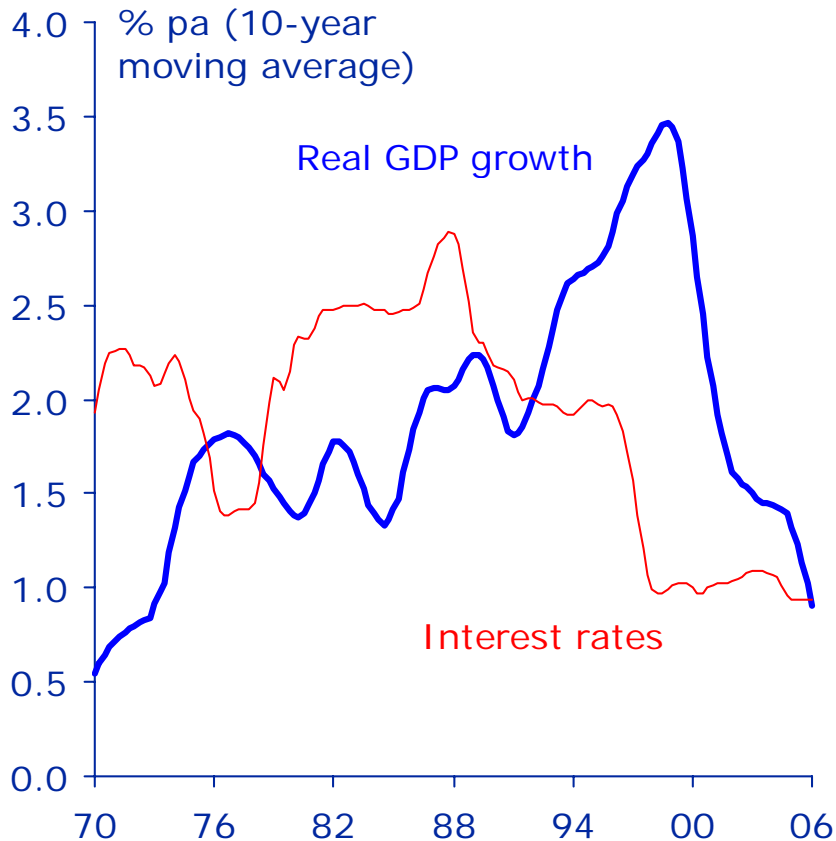
CBD office prices are, on average, 37% below their 1984 levels in real terms

Real CBD office prices

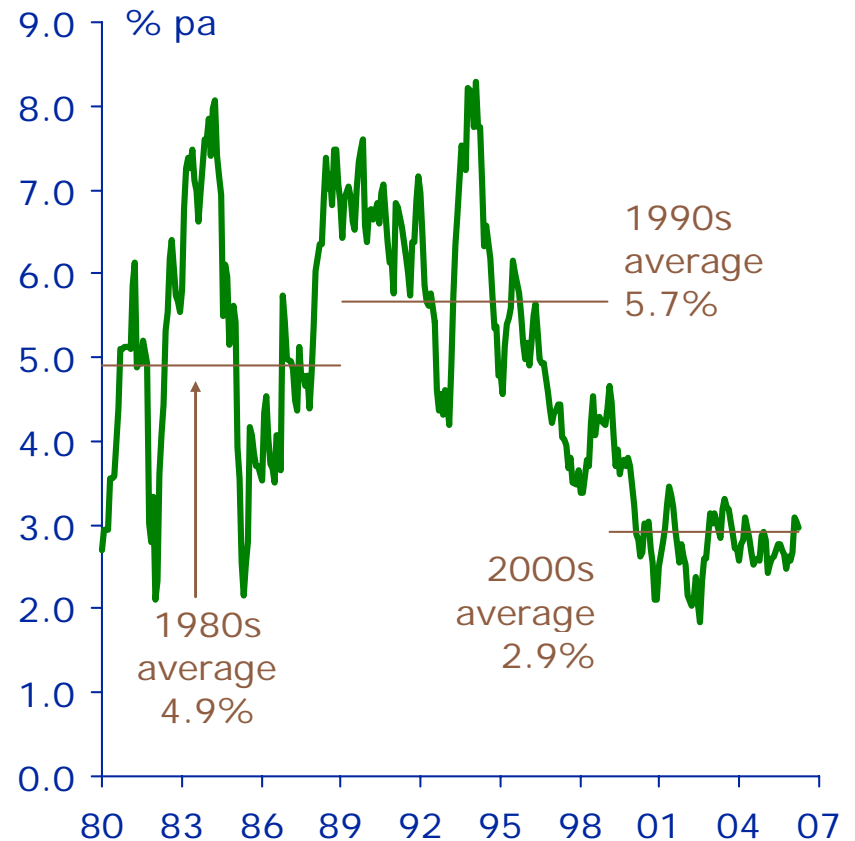


Heightened stability in the macro environment has seen real risk-free yields fall by nearly 3%

Volatility* of real GDP growth and interest rates



Real 10-year government bond yields

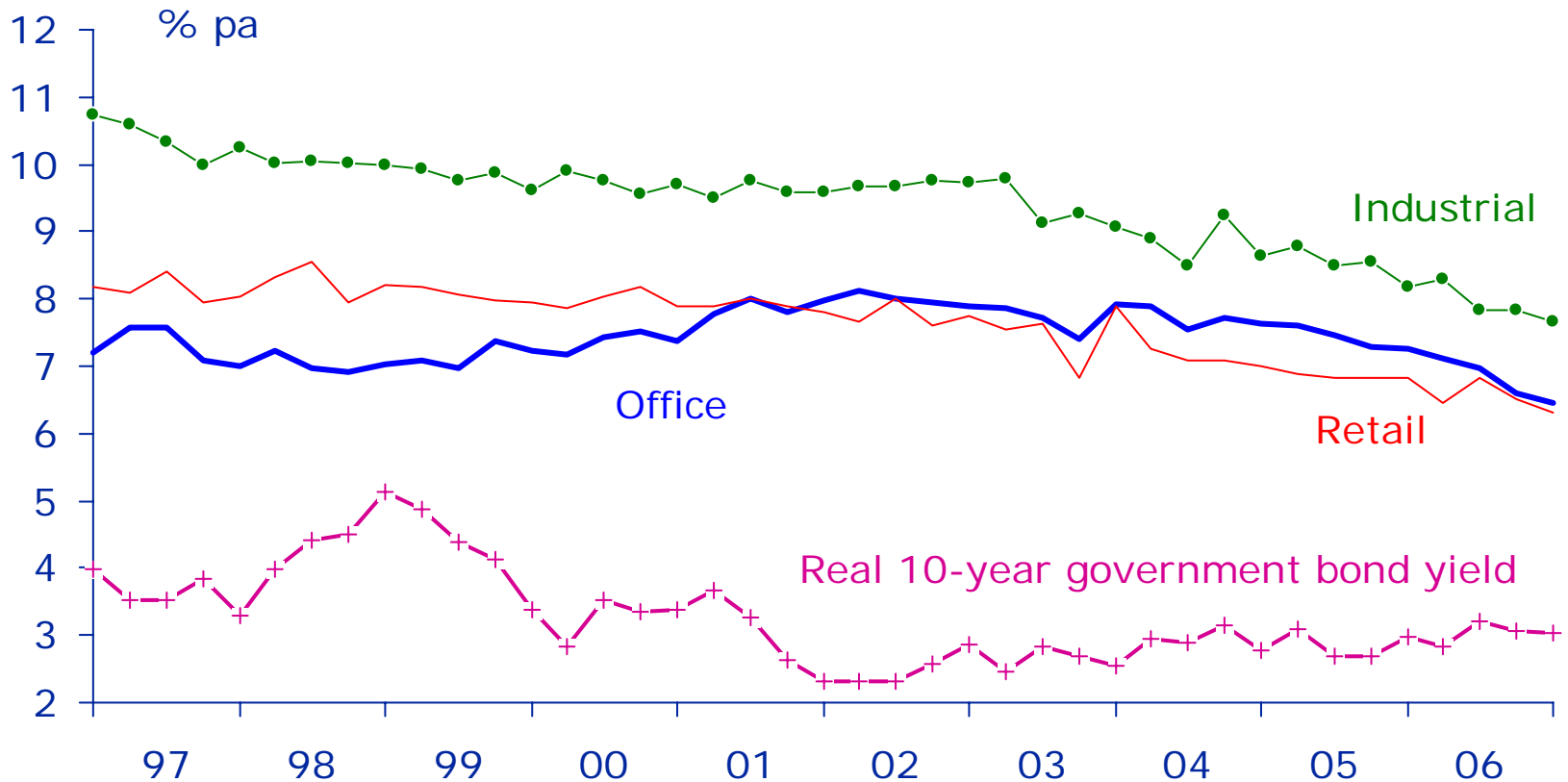


* Standard deviation.

Sources: ABS; RBA; Economics@ANZ.

The fall in the risk-free yield more than accounts for the decline in commercial property yields

Commercial property yields and real government bond yield compared

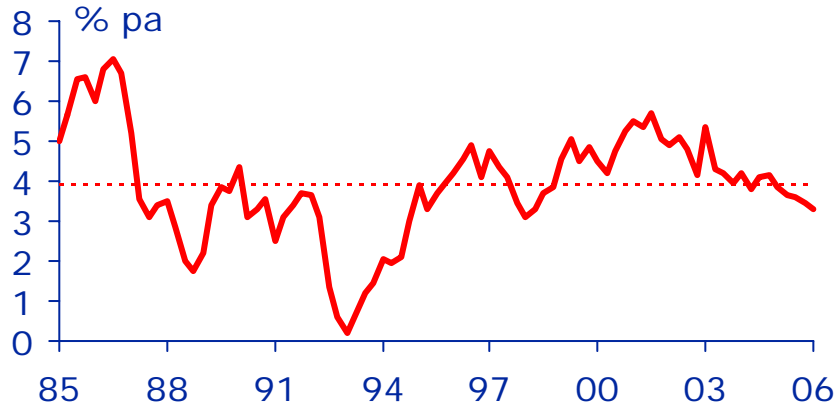


Sources: ABS; RBA; IPD/PCA; Economics@ANZ.

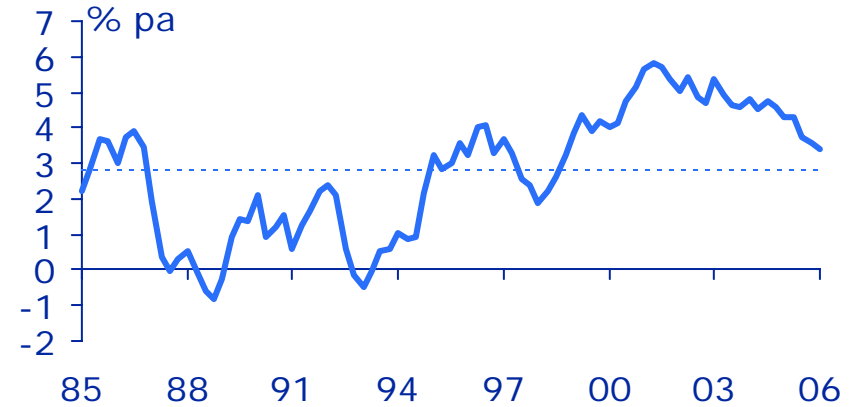
There is scope for the 'risk premia' on commercial property to decline further

Commercial property 'risk premia'

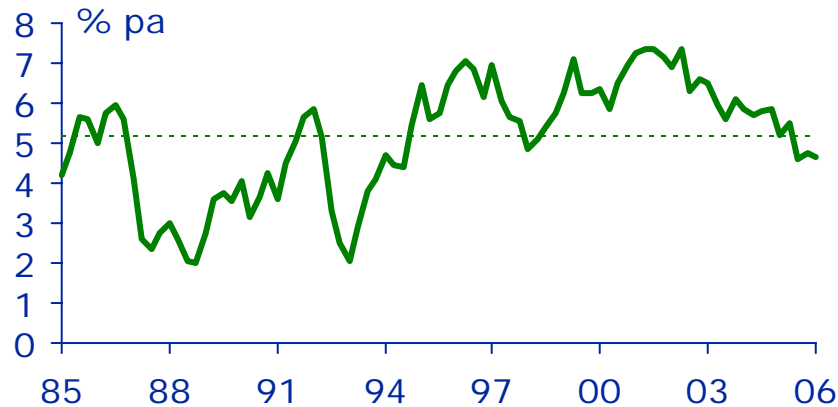
Retail



Office



Industrial



Note: 'risk premium' is the property yield (or capitalization rate) less the real ten year Commonwealth bond yield)

Summary

- The Australian economy has been performing well
 - partly reflecting improvements in the quality of economic management
 - but also owing a lot to a much more benign and stable global economic environment
- Economic growth is likely to pick up modestly over the next two years as the effects of the 'resources boom' continue to boost business and (including via the Budget) household incomes
 - though this will also put gradual upward pressure on inflation and interest rates
- Residential housing prices are likely to do no more than match CPI inflation, on average
 - although around that average the 'top end' of most cities will see further price gains while small declines are possible in less 'desirable' locations
 - residential rents are likely to rise further
 - the only way to 'fix' the affordability problem is to boost supply
- There is scope for commercial property yields to decline further over the next few years